The Market and Corporate Governance

- A Teach-In for Board Directors: "Or Everything You Wanted To Know About the Stock Market but Were Too Embarrassed To Ask", Plus an Argument for board-owner communication and Stewardship codes 2.0

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." /Mark Twain

What are we saying?

1. The market and the views of investors are not so alien as some directors think
2. There is a communication gap on strategic issues
3. Hence, we would like to see more company/board-owner interaction
4. A way to aid this interaction would be if owners could issue stewardship codes

Who is "the Market"? Or rather, how does the stock market work? Why does it react as it does? Why is our stock valued as it is? What do investors really want out of us? Board directors and executive managers at times have a strained relation to a stock market they view as short-sighted, moody and that infringes on their valuable time. Many are genuinely unsure of what makes this unruly monster tick and others base their opinion on what they read in the popular press.

The aim of the text

- Dissolve the mist on how the market works and what owners want
- Advocate communication
- Advocate yet another code…

In this text we aim to dissolve the mist of mystery around the stock market and point to the business implications of what investors want out of companies. More specifically we describe the type of investors that make up the markets, their strategies, the impact these have on the functioning of the market and how this is relevant for board directors. Further, we advocate improved communication between corporate executives and board directors on the one side and owners on the other plus what we call stewardship codes 2.0 as a cost effective way for institutional investors to develop as more business minded owners.

Picture 1. Who is the Market?

Source: reference.com

Target audiences

- Board directors
- Institutional owners

…i.e. the trustees and their principals

There are two target audiences for this piece. On the surface it is board directors in listed companies but our implicit ambition is also that long-term fundamentally oriented institutional owners of stocks will be able to find inspiration. As the board director is the trustee of the company's owners the two audiences are obviously linked. According to Wikipedia a trustee in a broad sense is "any person who holds property, authority, or a position of trust or responsibility for the benefit of other". But how does this particular trustee know what will benefit the "other", i.e. the owners?

Too often today the communication between a potentially dispersed ownership base of investors and the board directors is very thin and restricted to some very specific topics – the appointment of new directors through the nomination committee and the haggling over incentive schemes proposed by the compensation committee.

Even with a dispersed ownership the directors might appreciate strategy inputs

On top of this minority shareholder rights are discussed with regards to the annual general meeting (AGM) and the executive management at times find themselves at the center of a CSR discussion of some sort. And they get questions in relation to quarterly results. That's it. But that's not all of what it takes to run a company, it's not all that is on a board's agenda and it's not all that investors expect of their trustees. Still, investors, the owners, not always tell their trustees how they should work for their "benefit".

Disposition of text

Section 1 gives some national background, sections 2-6 tries to explain what the market is and what owners want from directors, section 7 addresses the IR-function and director-owner communication, section 8 argues that institutional owners should set up stewardship codes and section 9 is a summary

According to Michael O'Sullivan of Credit Suisse "*a great deal of the governance literature concerns itself with mechanisms, such as shareholder voice and the actions of the Board of Directors. Relatively little attention is given to the process by which management invests the firm's capital*". It is our view that the scope of corporate governance and of investors' communications with companies must expand, but that it has to be done in a budget efficient way that doesn't confuse the role of owners, board directors and others.

The use of "him" as instead of "him or her" is only a matter of convenience and should not be interpreted as anything else. By "we" we mean Investing-ByThebooks. However, the reader should note that the opinions of this text are those of the writer.

The Swedish Setup

"Maybe we should rename directors 'shareholder representatives' – then they would pull up to the table in the right mind-set." /Ralph Withworth, Relational Investors LLC

Quarterly capitalism as culprit…

Ever since the financial crisis 2008 there has been a lively debate among international bodies such as the OECD, the G30 and the World Economic Forum on how to move away from "quarterly capitalism" towards a more active and long-term stewardship of companies by the so-called institutional investors. The many public organizations questioned where owners and boards in banks had been when the executive managers of the banks made a great many bad decisions leading up to the crisis. The EU some time ago charged that "*the financial crisis has shaken the assumption that shareholders can be relied on to act as responsible owners*."

…and key selling point

Further, one of the selling points when private equity-advocacies state their case is that private equity funds are better corporate owners than those on the listed stock markets. The implied reason being that the PE boards minimize "ticking compliance boxes" and devote more board time to corporate strategy. Then, in 2012 the landmark UK Stewardship Code was launched and the UK followers have grown to around 300 investors and others. There are now similar codes in close to a dozen countries. However,

not so in Sweden.

The Code

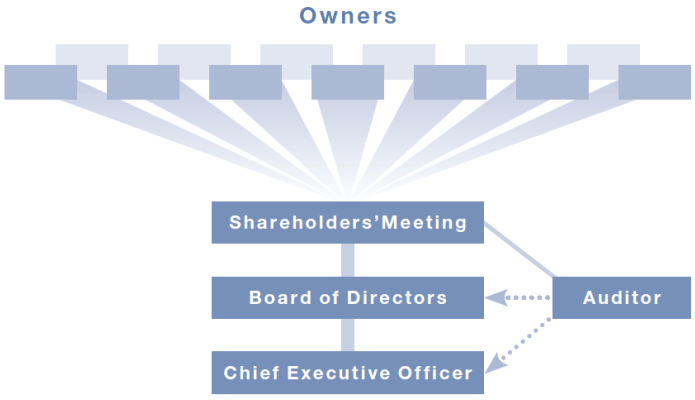
The *Swedish Corporate Governance Code*, commonly referred to as "the Code", in a section called *The Swedish corporate governance model* tries to describe the various roles of the actors involved in the governance of listed companies. With reference to the Companies Act, the Code describes the below pictured hierarchy. The ownership role is described as contributing risk capital, participating and exercising influence at the AGM and further it is stated that as long as minority interests aren't abused "*Swedish society takes a positive view of major shareholders taking particular responsibility for companies by using seats on boards of directors to actively influence governance*".

Outsourced corporate governance

Hence, since the AGM rarely will engage in the more business and strategy related corporate governance issues (henceforth strategic governance), the bulk of financial institutions have implicitly outsourced these issues to "major shareholders" that are expected to actively contribute to the governance of companies by siting of boards. By design the ownership role in the Code is divided into major shareholders that are left to govern the companies in peace and the other owners who don't have to spend resources on these issues. A win-win?

Picture 2. Decision Making Bodies

Pecking order



Source: The Swedish Corporate Finance Code, Swedish Corporate Governance Board, Dec 1, 2016

Can a broken link…

The problem is that in many Swedish companies there is no such major shareholder to rely on. In these situations the link between the owners and the board is broken with regards to strategic governance. Directors are left with empty phrases such as that they should work "for the benefit of all shareholders" or "in the best interest of the corporation".

Investors risk becoming something alien and perhaps even threatening in the eyes of the board directors despite the fact that they are the trustees of the owners. We think this is a wasted chance. Even somewhat smaller owners could potentially make valuable contributions to the discussion around a company's strategic governance. It would be a shame not to exploit all value creation opportunities.

The Swedish model is very much a Nordic model as the corporate governance in the Nordics is relatively similar. What is significant for this area compared to for example the Anglo-Saxon countries is exactly that there are a number of strong non-institutional owners on these markets. In our opinion the model has worked very well but it is not equally suited for companies without major owners. To protect this well-functioning model it has to develop.

…be mended?

So, how could this above described broken link be mended? In principle look favorably on a practice where the largest owners in every company state their intention with their ownership in the annual report of the companies where they are owners as suggested by Sophie Nachemson-Ekwall, Peter Benson, Lars-Erik Forsgårdh, Sussi Kvart and Meg Tivéus at DI Debatt, September 27, 2016.

Picture 3. Argues for Ownership Declarations in Annual Reports

Source: Bästa rapportering om värdeskapande 2015, PwC – tävlan 2016

However, a company-by-company approach would either be fairly resource and time consuming for the owners or, if not, would risk becoming standardized and bland. Further, publicizing strategic views on a company basis would put the owner in an awkward situation if the company chooses not to follow the advice – should the owner then sell his holding?

Presenting a view…

Hence, we feel even stronger that owners should present their general view on how they would want their portfolio companies in general to handle a number of business oriented issues. Internationally such codes are called a stewardship code or an owner's code.

Yes, such a stewardship code would require resources where the potential value creation benefits only partially goes to a minority owner, it would challenge conventions and with the large sums managed by asset management organizations with unions or the government as the principal it would require some banners against the politicization of the strategic governance. Further, we realize the mixed blessing of adding further complexity and formalities to the asset management.

…would have cons…

On the other hand, institutions would move from being seen as "the short-term faceless capital" to be viewed as responsible long-term owners with a positive contribution to the Swedish economy. In a large special feature last year Affärsvärlden defined the "faceless capital" as "mutual funds, pension funds and other institutional owners that do not care about long-term responsible ownership, but only seeks short term profits [our translation]. This is not the public position an institution wants to have.

…but also pros

Further, it could create value in the portfolios and it would definitely improve the input that institutions can have on issues like board nominations and the construction of executive remuneration schemes. It would put further focus on finding directors with business acumen, integrity and the ability to view issues long-term and as such also contribute to the further professionalization of how institutional owners handle their nomination committee duties. The chairman of the board is particularly crucial in avoiding a short-term focus.

On this note we cannot resist adding a wonderful quote from the always witty Warren Buffett "*Somebody once said that in looking for people to hire, you look for three qualities: integrity, intelligence, and energy. And if you don't have the first, the other two will kill you. You think about it; it's true. If you hire somebody without integrity, you really want them to be dumb and lazy*."

Hire people with

- Integrity
- Intelligence
- Energy

There is a lively debate internationally arguing against the special position of shareholders as owners of a company as opposed to other stakeholders. The less flattering short-termist and/or disinterested ownership behavior displayed by many investors does little to help in stating the case of the shareholders. By becoming more active, institutional owners could preempt populist initiatives from the political sphere.

Carl Bennet complains…

In Affärsvärlen Carl Bennet claims that CEOs get fixated with checking the stock price each and every day to try to infer the approval or disapproval of the stock market instead of focusing on developing the competitive ability of the company. Further, Mr. Bennet claims, although many institutions have come to take a more long-term stance, the short-termism of the stock market too often hinders companies making long-term investments, as announcing these would hurt the share price. This is not an uncommon view.

…as do Wolley and Vayanos that propose restrictions…

In the Central Banking Journal (Dec, 2012) Paul Wolley and Dimitri Vayanos go so far as to call today's ownership situation with a dominance of index based or momentum based investors a "market failure" that causes a misallocation of resources across the economy and that as such should be dealt with by regulation. They therefore propose a number of restrictions for institutional investors severely restricting their freedom to manage the capital. This might not become reality at the moment but after the next economic downturn the voices advocating such initiatives could potentially grow even stronger.

…while John Kay sees a solution

Some proposals are obviously more moderated than others. In the SNS report *Ownership After the Financial Crisis* (Ägandet efter finanskrisen), John Kay argues that institutions must move away from a negative ownership process of ticking off lists of demands and potentially selling the shares when they are discontent, to a positive process of meeting and discussing forward-looking

issues with companies.

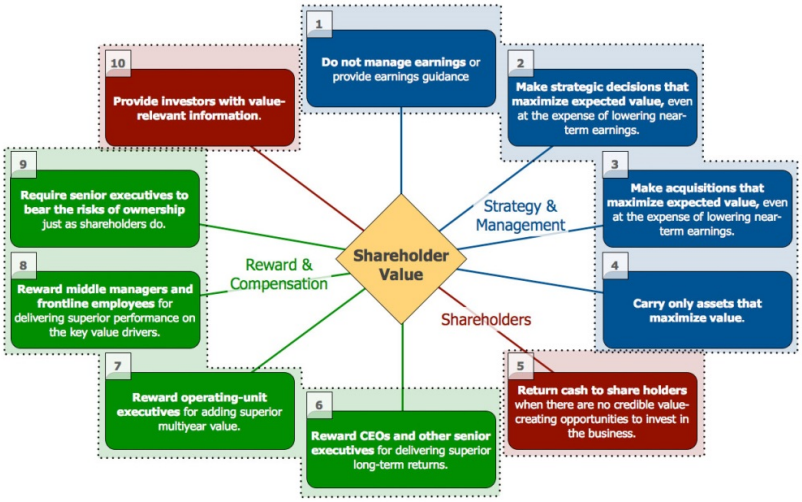
Complement CSR/ESG with strategy

In developing the ownership role it is obviously important that the roles of the decision making bodies in the Code's picture above don't get muddled and every company is obviously unique, but it could only be positive if institutions stated their principle opinions on various strategic governance issues. The strategic governance would as such complement the CSR/ESG and ownership policies already well developed today. Hopefully this would tilt the balance of the practices of the corporate governance area from compliance, board processes and minority shareholder rights towards issues like corporate strategy and competitive advantages. If so, it would be a change most welcome for many board members. We will come back later in this text with our suggestion for aiding this process through what we call stewardship codes 2.0.

What the Shareholder really wants – yes, it's true!

While we wait for the ownership role to evolve, we in this text as stated above also aim to demystify the stock market and also clarify which behavior best benefits the owners. With regards to the latter, there are several ways to approach and try to structure the topic of benefiting the owners – one is illustrated in the picture below. In this report we will focus on the value creating aspects of the actions of companies and their boards and on the interaction between companies and their owners (blue and red below).

Picture 4. Ten Ways to Create Shareholder Value



Source: Sebastian Kaiser, in turn inspired by Alfred Rappaport

Leave out incentive schemes

A topic we will largely leave out for now is the potential value creation from aligning the rewards and compensation in companies with the interests of their owners (green).

What Is the Market?

"*I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody*." /James Carville, political adviser to Bill Clinton

Journalists, executives and directors, but also financial analysts and portfolio managers, often talk about the Market as if it was a physical, living being that manifests itself through impulsive price movements. This is plainly not the case.

The market

The stock market is just that, a secondary market for stocks where everyone from algorithmic traders to sovereign wealth funds buy and sell securities and by this set their prices. There is no "the Market" and there is no typical investor. Understanding the market is to a large extent about understanding the different types of investors on it, their strategies and how these influence the price of a stock (and by this the current market capitalization of a company).

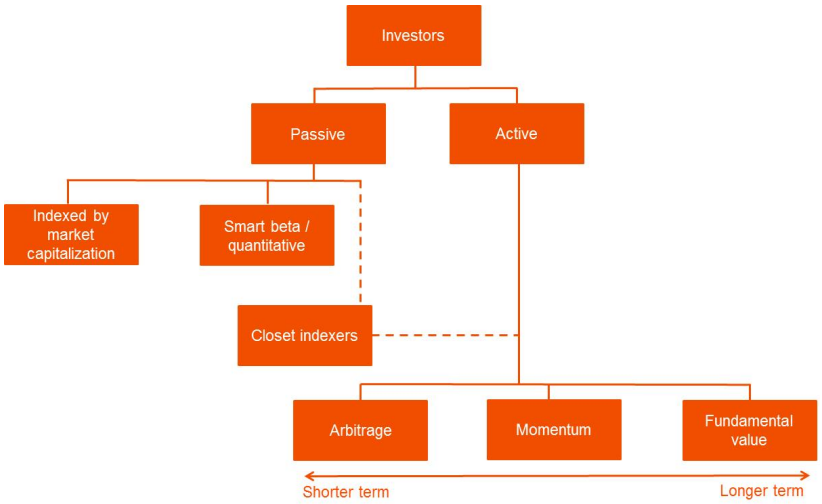
Categorizing investors

There is no one correct way to categorize investors but we would first distinguish between passive investors and active investors. The first kind is those who purchase all stocks in the proportion as they are included into an index.

A gross simplification of course

Passive investors generally don't take much notice of the company behind the security and with regards to the capital allocation of the society and the ownership governance, they are generally free-riders on the active investors. Among the second group, the active investors, we would point to three base strategies; fundamental value investing, momentum investing and arbitrage.

Picture 5. Investor Categorization



Source: The author

Fundamental value investor

The fundamental value investor performs research of a company's operations to try to establish a value of the company that is separate from the price of the stock at the moment. If the value is higher than the price he is a potential buyer of the stock and vice versa. Warren Buffett has expressed this as "price is what you pay, value is what you get". The premise is that in the long-run price and value will converge from time to time. Hence, the time horizon of a value investor is generally 2-5 years or even longer and he often holds a more concentrated portfolio.

Growth investors

In popular press value investors and growth investors are often seen as each others' opposites. However, a fundamental growth investor will also purchase a stock because he is of the opinion that the value of the stock is higher than its price – he simply focuses on companies that create value through a high amount of corporate growth. The longer time horizon and the focus on fundamental analysis is the same. Hence, in the concept "fundamental value investor" we include fundamental growth investors.

Momentum investors

The momentum investor instead bases his strategy on the opinion that the current trend in earnings growth, sales growth, stock price etc. will continue for yet a while. This trend following investor could partially look to corporate fundamentals but he will mainly look to the continuation of short-term trends in these over the next 3 to 18 months or so. The premise is that there is so-called autocorrelation in certain types of datasets on financial markets.

Even though the trend following investor could look at some limited sets of fundamental corporate data he rarely performs a very deep research of companies' longer term prospects and some momentum investors only look to the share price development.

The arbitrageur

The arbitrageur will instead try to find securities with some sort of similarity but where the prices between the two securities differ in a way that could be expected to correct. This strategy has over time seen increasingly shorter investment horizons and many of the algorithmic high frequency traders use arbitrage strategies.

All of these three above strategies could be so-called long-only or long-short. In the latter case you not only take positive portfolio positions in securities you believe will increase in value but also negative portfolio positions in securities you believe will decrease in value.

Not clear cut

The world is seldom as clear cut as described above but the distinctions are still useful. Some investors who index their portfolios don't use market capitalization indices, but instead an index that in itself takes an active bet on an investment style such as for example value as defined by low valuation multiples or momentum as defined by earnings revision trends.

In this case the investment is active as it is making a choice but with regards to making judgements on the fundamentals of the individual company and the process is passive. This is pretty much where many quantitative investors are and where all the today so popular smart beta strategies could be classified. To add to the confusion the degree of activity in the active corner of investing

is obviously a range and many of the self-proclaimed active fundamental investors are rather more passive-ish than truly active. These are at times called closet indexers.

We recently heard a person make a distinction between owners that are long-lasting versus those that are long-term that we really liked. An index fund will for example be long-lasting as it will own a company's shares as long as they are a part of the index. It will not however be long-term in the meaning that it will not have a view of the long-term fundamentals of the company.

Long-lasting vs. long-term

A value investor will generally look to the long term future of the company but if the share price rises sharply making it overpriced compared to those long-term fundamentals, he might not stay as a long-lasting owner. Although we think the distinction is very apt it is not necessarily how we use the phrase long-term going forward.

Picture 6. The Dreaded Activists

Like the Ichan picture!

Left to right: Christer Gardell of Cevian Capital, Bill Ackman of Pershing Square, Dan Loeb of Third Point Partners and Carl Icahn of Icahn Enterprises. Source: Google Pictures

As a side note, so-called activist investors are most often fundamental value investors that are not content to sit around and wait for the price to converge to the higher estimated value by itself but instead orchestrate their own trigger event for the revaluation by actively engaging with the company.

Activist investors

Activists campaign to change management, business structures or to make the company distribute excess cash or even to combat what they see as wasteful and extravagant managerial behavior for which the owners are paying. As such one could say that activists fill the void left by other institutional investors.

However, although many activists do long term good for all shareholders by confronting adverse practices by poor corporate executives there are other activist campaigns that in reality are more like a smash and grab heist to the detriment of long term shareholder value. Not all activists can be counted on to take the view of all shareholders. Board directors should in all cases learn to understand what activists target.

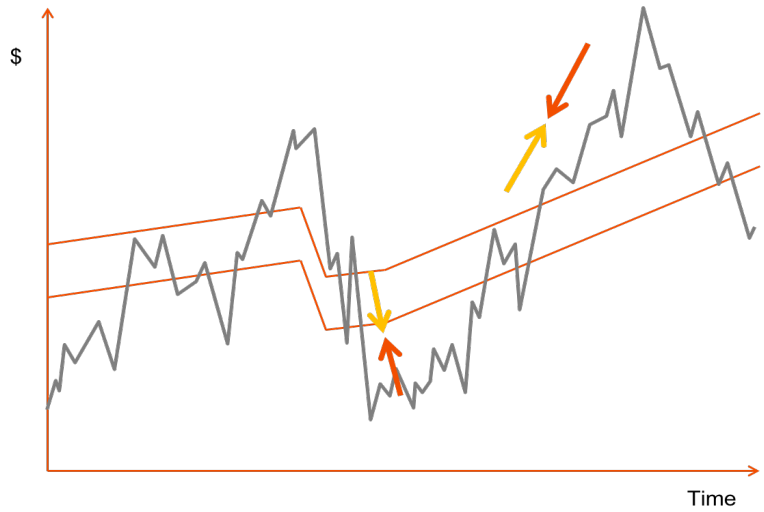
In contrast, the arbitrageurs iron out very short-term price imperfections and matter little for a company or its valuation in the long-run and can as such be ignored by directors. The more important functionality of the market is the power struggle between value investors and momentum investors. As momentum investors react to an already established trend they amplify these and in most cases push the share price away (upwards or downwards) from the estimated intrinsic value of the value investor.

A tug of war

The longer a trend persists the more obvious is the momentum signal to trade on, but on the other hand the further away from the intrinsic value the price is, the larger the incentive for the value investor to go against the trend. The further away from a fair range for the intrinsic value that the price is the more intensive the struggle becomes and on average the volatility of the share increases.

Picture 7. The Power Struggle

Momentum rules in the short-term but…



Source: The author

…value investors are like gravity…

As such the buying and selling of the fundamental value investor is the stabilizing force that brings the price back towards the perceived intrinsic value. Fundamental investors trade less frequently but often buy or sell in larger quantities when they do trade. In the picture the yellow arrows symbolize momentum investors pushing the (gray) price away from the estimated fair value range (between orange lines) and the red arrows symbolize the value investors' moderating actions. In the short run momentum investors tend to dominate but in the long run value investors, like a gravitonic force, are the ones that set stock price levels.

…and set the long-term price level

From a board's perspective, with regards to who determines the long-term market capitalization of the company, the investors that count are the fundamental value investors – the rest are mostly noise producers or irrelevant on anything but shorter time horizons. Hence, in practical terms "the Market" that board directors should concern themselves with is the collective of fundamental value investors. They view themselves as part owners of companies while many of the others are mainly managers of security portfolios.

This doesn't mean that arbitrageurs, index investors, trend followers, quantitative hedge funds etc. aren't all legal owners and as such should receive fair treatment and equal information, but in our view it means that a company could tailor its information to better suit the investors who really matter for them.

They are still investors first

Still, just because the fundamental value investors spend time researching the company, its business and also the management this doesn't mean that they view the company as the corporate management does – the investors are still portfolio managers and analysts. For a portfolio manager the company will in effect be a coworker to himself in the pursuit of making his investors' money grow.

The Short Sighted Stock Market

"[…] I can tell you that the shareholders you hear from most often are often only worried about next week. The shareholders who are thinking longer term tend to be less vocal. That has to change." / Michael Sabia, President and CEO of CDPQ

Hyperactive prices and short-term focused questions

But if the long-term fundamental value investors are the ones in command why is the stock market seemingly so short-sighted? The share price jumps around as crazy at reporting dates and not always for obvious reasons. There are a number of points to bring up on this topic. Many investors really are short sighted, or at least they use strategies with short time horizons, and at any specific moment they heavily influence the share price. And sometimes external macro factors and crowd psychology blur the reaction even further.

As we saw above it takes all kinds of investors to make a liquid market and if short-term reactions at times seem illogical to corporate insiders it is generally because events are not judged by whether they are good or bad, but rather if they are better or worse than investors expected.

Don't take it personal

The fact that stocks move because the turn-out of something differs from the expectation on that something also explains why "good companies" not necessarily are good investments. The excellent future might already be built into expectations and by this into the share price. This is exactly why CEOs must stop taking it as a personal insult when the share price now and then dwindles.

Picture 8. "A Normal Day at the Nation's Most Important Financial Institution"

Sorry, if you've seen the picture before but it's so very good

Source: epicurandealmaker.blogspot.se

Complicating the view

Time horizons tend to fluctuate with the psychological climate over the stock market cycle. However, we are not so sure that the individual investor intrinsically has become more short sighted than before and we are relatively certain that the time horizon of the investors that count for the company – the fundamental value investors – hasn't shortened.

Looking way into the future

Anyone who believes that all that investors care about is the maximization of quarterly EPS numbers would have a tough time explaining the share prices of loss making biotech or technology companies where any potential profits are several years out in the future. The market capitalization of Amazon is about USD 360bn. The average yearly net profit the last few years is slightly less than USD 0.5bn. For anyone instead correctly viewing the value of a company as the discounted present value of expected future free cash flows all this makes perfect sense.

But the turnover

The smoking gun when it comes to proving myopic investor behavior is the annual turnover rate on the stock market. A turnover of for example 50% equals an average holding period of 1/0.5=2 years for investors. The turnover has indeed increased compared to the 1950s to 1970s.

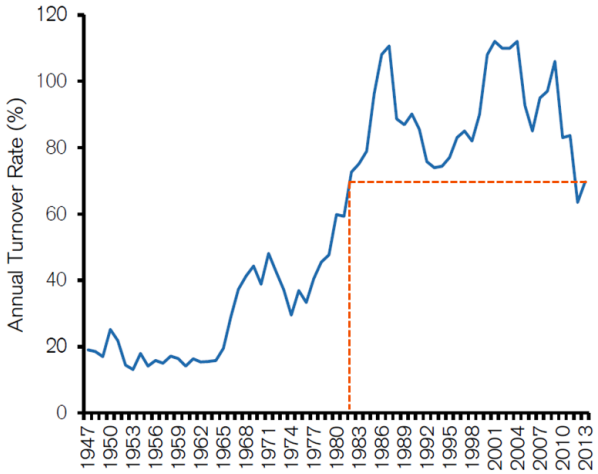
The thing is that compared to that period the cost to trade stocks today are about 1/100th of the previous price level. At least some of the increase in turnover is due to frictional costs disappearing and by this allowing for new types of investment strategies having the potential to be profitable.

Price and mix

A high frequency trading strategy in the 1950s would for example have ruined the investor in a week due to the high trading costs (imagining he would have had access to the computing power to execute such a strategy). The turnover rate must instead be judged per investor segment, per strategy, and while the mix of investors varies over time, the time horizon per investor segment probably hasn't changed much.

Picture 9. Average Annual Turnover Rate US Stock Market 1947 - 2013

100% = average holding period of 1 year



Source: Bogle Financial Markets Research, The author

Hyperbolic discounting

We're not saying that a mix induced shift in turnover doesn't count and among others the Bank of England has shown evidence of so-called hyperbolic discounting where profits further out in the future are discounted with a higher cost of capital, but it still implies more of a technical influence rather than a changing behavioral one on the part of the owners.

Index funds and ETFs

As a side note, looking at the picture above the turnover has in fact decreased since 2010 and in 2013 it was the lowest since 1982. We would guess that the reason is partly the increased assets under management in index funds and partly a smaller amount of trading around positions among closet indexers. While, we haven't any more recent data we would think that the turnover has increased somewhat today compared to 2013, but hardly dramatically as index funds and ETFs continue to take market shares.

Anecdotal evidence

Much of the perception of short-sightedness further relies on the anecdotal personal evidence of directors and executives. In this there is a sort of micro-macro perception problem. It is not really possible to judge the functioning of the market by listening to individual investors. The questions asked on an earnings call might be related to marginal information but the ownership of the company in a portfolio could still be based on a long-term view.

Also, CEOs etc. to some extent gain a faulty perception as the investment banks who arrange many of the meetings bring forward closet indexers and momentum investors more than others. The simple reason is that they often have either very large portfolios or that they trade a lot – hence they are good customers for an investment bank that lives out of facilitating the trading.

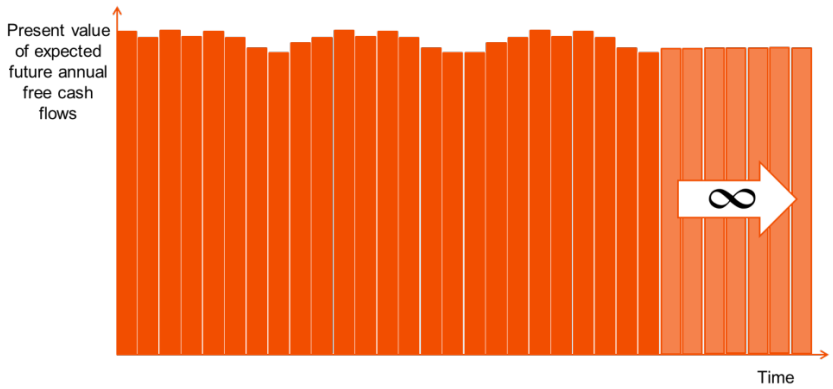
Long-term view doesn't equal never trades

Importantly, an annual turnover of for example 100% does not imply that the average investor is indifferent to what happens to the company beyond the next 12 months. Even if the market only consisted of longer-term fundamental investors individual corporate events could still trigger large price movements. If we accept the premise that the value of the company is the discounted present value of expected future free cash flows, then we must unfortunately also accept that the exact value of the company is unknowable (except in very unusual situations).

Hence, every individual fundamental investor will form his view of what the value of the company is, a view that builds on his projection of the future cash flows into eternity. This necessary uncertainty about the future is (together with speculation) what creates the volatility in share prices.

Picture 10. Investor's View of Expected Value of Company

The future is unknowable



Source: The author

Value investing – buy when estimated value is higher than the price, sell when the opposite

Despite the hopefully diligent research each fundamental investor will have a different view of the future and by this also a different view of the value of the company. Depending on this particular view, different fundamental investors will be willing buyers and sellers of the share at different prices. At some share price one fundamental investor will think that the value is higher than the market price and he will be a buyer, while another fundamental investor will have a different view of the value and think that it is lower than the market price at the moment and he will be a seller.

Together all investors will constitute the supply and demand of traded shares at different price levels as pictured by the below very simplified Economics 1O1 chart. The share price is set in the intersection between the marginal buyer with a slightly more positive view of the future and the marginal seller with a slightly more negative view. The point we want to make is that the supply and demand lines aren't just lines in a textbook; they are a set of people that now and then change their interpretation of how the future will look.

Near term data can change long-term view and …

Now, say that a quarterly report convinces a number of long-term fundamental investors that the future free cash flow stream actually looks different from what they previously thought, then the supply-demand balance

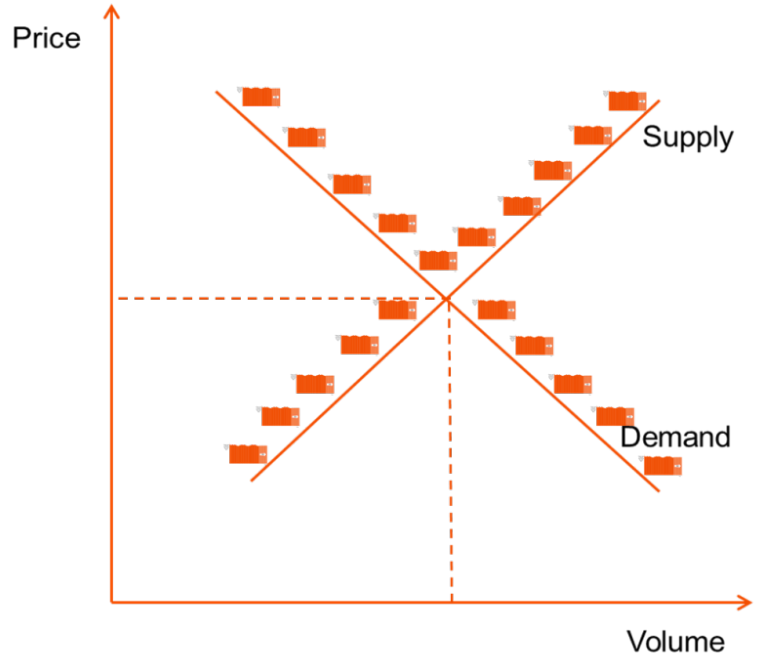
among long-term investors will shift causing a momentary correction of the share price. Investors here trade on short-term information, moving the share price, but they still bet on long-term outcomes.

…shares move on changes in perceptions of the future

The share price moves on changes in investors' expectations about the future, not by the changes in corporate fundamentals per se. Hence, an earnings announcement is new information that in this case leads to changes in the long-term view of the marginal investors.

Picture 11. Supply and Demand

In the short term both the slopes and bends of both supply and demand of shares look materially different but in the long run this is correct



Source: The author

A dilemma

Okay, we all agree on the fact that directors are the trustees of the owners; does the now gained knowledge of investor categories and their market influence help them? Just because fundamental value investors set the prize in the long run directors cannot discriminate against other owners. Further, how can directors in a company with dispersed ownership learn what the owners want when so many of them have conflicting agendas and you as a director should work for the benefit of all the owners?

The director's expanded responsibility: all shareholders in eternity!

To solve this dilemma we suggest that they expand their responsibility even further and think of themselves as not only the trustee of all shareholders today but the trustees for all shareholders for all eternity.

The shareholder vs the Shareholder

Let us explain what we mean by this crucial point. It is important to differentiate between the individual portfolio manager of a shareholder on the one side and the Shareholder (with a capital "S") in a more general meaning on the other. The PM of the specific shareholder is to some extent trapped by demands to at every moment have a better performance than his competitors – and definitely not worse. This creates a myopic behavior that he probably knows is not very conductive but he is ensnared in an iron grip of short-termist

journalists and savers and annual incentive schemes created by bosses who want to attract the short sighted savers and who fear the myopic journalists.

The collective Shareholder owns the company forever

The Shareholder with a capital "S", i.e. all current and future owners as a collective, will own the company as long as there is a company to own. The Shareholder owns the company and cannot sell his shares. For the Shareholder the creation of shareholder value is as such something extremely long-term.

The Shareholder is the principal

The board director should listen to the Shareholder and not to the shareholder. As we try to show below we would argue that this is what best benefits society and for the corporations it solves many of the practical issues with regards to how to view their perhaps dispersed owners.

Focus on the important stuff

If corporate insiders mentally could switch to viewing the Shareholder as their principal (rather than the current share price) this would do so much more to foster longer-term behavior than superficial issues like whether financial reporting should be released quarterly or not. In our view it is better to gain perspective on what the share price is, what it isn't and understanding the issue of price versus value than stop giving quarterly information.

Shareholder value is not the same as maximizing current profits or share price

The value of the company for the Shareholder is the sum of the present value of all future free cash flows into eternity, discounted by a cost of capital or an opportunity cost that is supposed to reflect the risk in the company. Free cash flow is the cash flow left after all other stakeholders than the shareholders have received payment and the company has made required investments to maintain its business.

Hence, the task of the board is on a theoretical plane to optimize the balance between all other stakeholders in the company and by this sustain the business to maximize the present value of the future cash flow stream. The task is most certainly not to maximize the profit or share price in the next quarter or year as this most probably will result in a sub-optimization that will lower the present value of the future cash flow stream.

In the next section we will discuss how to create Shareholder value in more detail. This section is meant to present a high level picture of how fundamental long-term value investors, in our view, see the topic of corporate value creation, i.e. how corporate insiders, board directors and executive managers, should do their job.

Value Creating Governance

"Since it is logically impossible to maximize in more than one dimension." /Michael C. Jensen

The primary tasks of the board is as we view it to:

Tasks

- What to do?
- Who will do it?
- Is he doing it?
- Report back

…but why?

1. decide on the mission and goals of the company plus the strategies to reach the goals, including deciding on capital allocation, financing and M&A,
2. appoint the CEO who is to execute on the strategy, support him in his efforts and decide what to pay him, while also having a plan B for the case the CEO cannot fulfill the role,
3. monitor both the health of the company and the execution of the strategy as well as the changes of the business environment to make sure the strategy is still relevant and
4. report back to the owners on the progress in the form of the annual report and its financial accounts.

This is all fine but what is the point of it all? What is the purpose of doing all this?

The purpose is the create Shareholder value

In our view the aim is to create Shareholder value (with a capital S to highlight that we are talking about long-term value creation for the collective shareholder as discussed above). Although it isn't explicitly stated that the purpose of a company is to generate value for its owners it is at least implicit in the Swedish Companies Act through the statement "If the company as a whole or in part has a purpose other than to generate profit for distribution among shareholders this should be specified in the Articles of Association".

Further, the Code states that "Good corporate governance means ensuring that companies are run sustainably, responsibly and as efficiently as possible on behalf of their shareholders" and further that the board of directors amongst others have as a task to "govern the company's conduct in society, with the aim of ensuring its long-term value creation capability."

Picture 12. The Good Guys

We know, this is not what shareholders look like today…

Source: the Economist

Even without the endorsement of Swedish law and of the self-regulation there are more fundamental reasons why Shareholder value is a key metric in a market economy.

Allocation of limited resources to their best use

The resources of a society are limited. Hence, it is critically important for the wellbeing of all people in that society that these resources aren't squandered but instead used as efficiently as possible. If they are not, everyone will be poorer. The way to achieve this is to have a mechanism that efficiently allocates the resources to those entities that generate the maximum output on the resources they use – in today's society this is to a large extent the stock market.

The pursuit of Shareholder value and the capital allocation of financial markets create a system that builds prosperity in society. Unless an input is put to its best use it is underperforming relative to its opportunity cost. Successful capital allocation means converting inputs like money, ideas and people into something more valuable than they would be otherwise. In the long run a company that puts its capital to better use than another will be the one that survives.

Receiving the residual cash flow

The fact that the Shareholder receives the residual cash flow that is left after all the other stakeholders have received their compensation has hugely important implications as it means that the interest of the Shareholder and the role he has to handle is to balance all the other stakeholders.

No company can in the long-run unduly exploit any of its stakeholders in a society where there is free choice since those unfairly treated will simply choose not to engage with the company (or close it down if the stakeholder happens to be the state). As a company depends on all its stakeholders this would destroy Shareholder value as there would be no future cash flow for the Shareholders.

As the popular press has created a perception of shareholder value generation as something that comes at the expense of other stakeholders it is vitally important to understand why the various groups are not in conflict. The differences in perception boil down to the view of a growing economy versus an economy of a fixed size.

When the capital market in a free economy allocates resources to companies that through innovation and improved efficiencies use society's scarce resources to the best effect in accordance with what customers want, this causes the economy to grow. A larger cake will over time benefit all stakeholders. We cannot stress this point enough, since the process of generating Shareholder value makes the economy grow it is in all stakeholders' interest as they all will gain considerably more cake over time.

A growing cake benefits all stakeholders

However, those who picture a cake that always will be of a fixed size will instead interpret the shareholder's claim on the company as a one-sided way to grab more than his fair share of the presumed fixed resources. This view is simply plain wrong. History has time after time disproved the perception of a fixed sized cake to fight over.

This obviously doesn't mean that we think companies should be totally unrestrained. If there are externalities like environmental effects that are not correctly priced then the democratic process must hastily and forcefully make sure that they are priced acceptably. If these externalities transcend national borders countries will have to cooperate in this price setting. In case of so-called market failures or of companies unduly distorting competition this must be regulated. Corporations must obviously work within the boundaries set by society.

Externality – a consequence of an industrial or commercial activity which affects other parties without this being reflected in market prices, such as the pollination of surrounding crops by bees kept for honey. /Wikipedia

The concept shareholder value has been kidnapped by fixed-size-cake-agitators that claim that it stands for exactly the things the originators of the concept was fighting against such as short term maximizing of profits or share price at the expense of the future or society at large.

Some Theory

To explain this better we need to look further at the creation of Shareholder value. If we assume free cash flows that grow in perpetuity at the constant rate of g, the Shareholder value of a firm, V, at the time, t, can be written as:

Now for some light equations

$$V_t = \frac{FCF_{t+1}}{WACC - g}$$

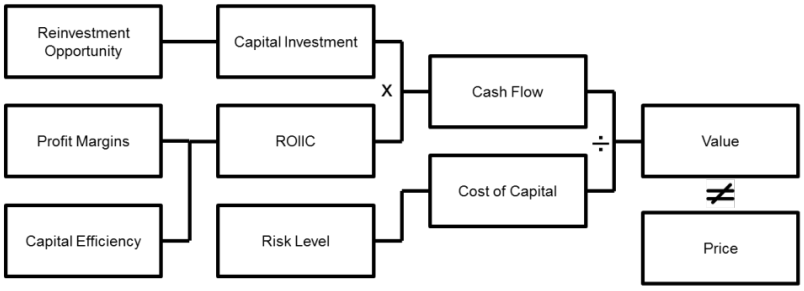
Equation 1

In equation 1 FCF stands for free cash flow and WACC for weighted average cost of capital. The picture below tries to unravel the factors behind the cash flows, the growth rates and the cost of capital. Even though the picture could be made infinitely more detailed, what is clear is that value creation is a balancing act where the optimal balance of capital investment, cost allocation and prudent risk taking over time creates Shareholder value.

A balancing act

Picture 13. Value Creation

Share price does not equal value since the price can only reflect the marginal investors' estimate of future free cash flows



Source: The auhtor. ROIIC = Return on Incremental Invested Capital, i.e. the return on an additional investment. Risk Level includes both operational aspects and capital structure.

We often feel that it is more illustrative to think of the value creation process arranged in another way than in equation 1. With some cleaver derivations the mathematically inclined can show that the equation above can be rearranged:

Value = invested capital plus net present value of EVA

$$V_t = IC_t + \frac{EVA_{t+1}}{WACC - g}$$ Equation 2

In equation 2 IC is the capital invested in the company and EVA stands for economic value added (sometimes called economic profit). EVA in turn is the IC multiplied with the spread between ROIC and WACC. Bear with us and look at it this way, value is created by a company when capital is invested at a higher return on the invested capital than the cost of the invested capital. It's really that simple, although at times hard to accomplish in real life.

EVA = (ROIC – WACC) * IC Equation 3

In previous *Companions* we have used the example of Ebberöds bank to illustrate this process. If you as a company have the chance to borrow from a bank at an interest rate of 4% and at the same time deposit the funds at the same bank at an interest rate of 8% (the actual rates from the 1923 play) then you as a bank customer would have a positive value spread, the "ROIC" is higher than the "WACC" with the above financial jargon.

Value creation: invest capital so that it gives a higher return than its cost

This positive value spread wouldn't do you much good if you were only allowed to borrow and invest the very limited amount of say SEK 1, as the capital invested into the value spread would be so small. Capital prudence is a virtue for a company but when there is an opportunity to earn good money you should go for it. In the end it boils down to having reinvestment opportunities to deploy the capital belonging to investors into projects, business, divisions etc. that have a future higher cash flow return on capital than the cost of capital for that capital. It is the combination of return on capital and growth ability that drives value creation.

Easier for some than for others

The level of return on capital is in itself often highly dependent on which sector the company is in and on the level of competitive advantage that a company has, alternatively the amount of barriers-to-entry for new competition. A key task for building Shareholder value is then to try to increase a company's competitive advantage and to build moats against competition. Otherwise new competitors will be attracted to the high return area and the added competitive intensity will bring down those returns.

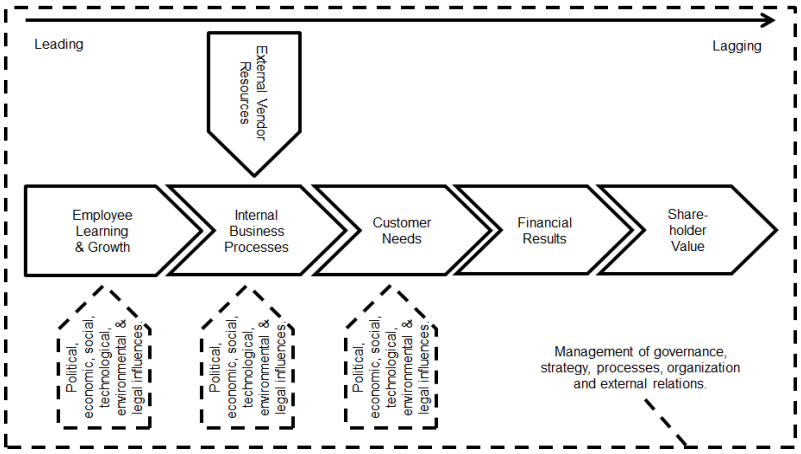
If this all sounds like some theoretical academic ivory tower mumbo jumbo far removed from real business we can assure you that it is not. Shareholder value might be created by financial results but a company can only create satisfactory financial results by satisfying customer needs by way of an internal business process (and usage of external vendor resources) that adheres to all the restraints that society places on the company. Further, the internal process will not be able to satisfy customer needs without employee learning and growth.

"Happy employees ensure happy customers. And happy customers ensure happy shareholders – in that order." /Simon Sinek

The role of the board of directors and the executive management is to govern the whole corporate eco-system by setting goals and strategies plus handling the execution of what's been decided. To succeed it will be important to align goals, strategy, measurement, operations and compensation with the purpose of value creation.

Shareholder value is not a strategy, it's the purpose

Picture 14. Value Creation as a Business System



Source: The author, inspiration Robert S. Kaplan & David P. Norton

It is financial factors like cost efficiency, capital efficiency and profitable growth, that create a positive spread between ROIC and WACC and by this build Shareholder value. However, it is the strategies, operations and corporate culture of the company that build the customer value and create the competitive advantages that provide the base for the financial performance. Value creation comes from an adept usage of scarce resources to satisfy a customer need. To succeed in this the corporate executives must skillfully balance the interests of all stakeholders. To maximize shareholder value you often operationally have to aim for other goals than the financial metrics itself – or at least there has to be a healthy balance.

Value Based Management

Value based management – the management practice/approach that aims to build Shareholder value

Value based management is a huge area and we will only touch on some key topics. The CEO has to find a balance between entrepreneurship and discipline, between focusing on the broad picture further out into the future and the execution of near term tasks. Perhaps the trickiest task for directors and executive managers in all this is to balance the near term profitability and costly initiatives meaning to strengthen the long-term prospects without having perfect insight into the future. Even though the end result of all investments is unsure the present value functionality of a Shareholder value model at least offers a mechanism to handle the balancing act.

Balance today and tomorrow

The board is in a very natural position to steer this balancing act between today and tomorrow as the executive management could risk being too wrapped up in day to day activities. For example, the board could encourage a more active capital allocation process with less of anchoring on prior years' allocation. A more distinct capital alignment to the forward looking strategies meant to build Shareholder value should be an important part of the budget discussion.

Growth is an amplifier

Further, the board should show zero tolerance for value destroying organic growth. Growth can be seen as an amplifier of value creation; growing a business where ROIC is lower than the WACC will only fasten the value destruction while growing a sufficiently profitable business adds value.

If one looks to the companies that have succeeded big time, growth will almost always be a big part of their success. By only looking to those that succeeded this creates an illusion that growth is something unequivocally good. What is not seen are the many companies that shot themselves in the foot by engaging in value destroying growth and over time faded away into obscurity. So while higher ROIC is always a positive as long as the current increased level isn't at the expense of the future, growth could be both a positive and a negative.

Efficient capital structure but err on the cautions side

Adjusting the capital structure of a company is rarely a huge factor in its value creation but companies that work with too high leverage instead risk jeopardizing the value they have already built due to an inability to withstand temporary setbacks. Our view is that companies should have an efficient balance sheet in relation to the variability of their operating profits over the economic cycle and there has to be a fit between available resources and the strategy to be executed. However, we also think that companies perhaps could be allowed to err on the cautious side as there is often an unappreciated option value in having dry gun powder in tough times when distressed assets from suffering competitors come out for sale at bargain prices.

The base rule of capital allocation is that a company should retain capital if it without overoptimistic assumptions can expect to earn a rate of return from investing it that is higher than the cost of capital – and distribute the capital to

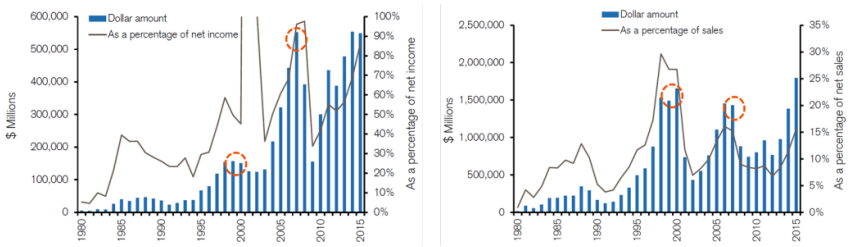
the shareholders if it cannot. Principle #5 in picture 7.4 states this as "*return cash to shareholders when there are no credible value-creating opportunities to invest in the business*".

In managing the balance sheet we would further encourage the board to take a more long-term, through the cycle view than we occasionally observe in real life. Too often boards approve share buybacks and acquisitions when the company has an ample supply of cash flow and the cash is piling up. Unfortunately this generally coincides with the periods when share prices – both of the company itself and of M&A targets – are expensive.

Please be more counter cyclical!

For the faithful long-term owners that stay with the company it would be much more value creative if companies sat on the cash for a while and made their purchases in less buoyant times – buy high and sell low has seldom been a way to build riches. If the urge to purchase a company in boom times becomes too hard to resist, at least try to pay with shares rather than with cash.

Picture 15. US Buybacks (left) and M&A (right), 1980-2015



Source: Michael J. Mauboussin. The author. The stock market peak years 1999/2000 and 2007 are circled.

But isn't all this to overcomplicate things? Why couldn't the goal just be to maximize EPS? The problem with EPS or net profits is that it's a number that can be increased while destroying Shareholder value either by underinvesting or by overinvesting. The fastest way to increase current profits is obviously to cut costs or refuse to invest irrespective of dire long-term consequences of the actions. This underinvestment will cause current EPS and ROE to rise but Shareholder value to decline.

Q: What's wrong with EPS?

Alternatively, if a company uses capital to make an investment that gives a 1% return the effect on EPS will initially be positive and the larger this poor investment is the larger the positive effect on EPS. This overinvestment is the equivalent of lending money from the bank at one rate and then deposit it at a lower rate – it's obviously good for the bank but you as a customer will not create any value and just because the interest earned on the depository account will be higher the larger the sum deposited this doesn't mean that it's a good idea to borrow more. So "make strategic decisions that maximize expected value, even at the expense of lowering near term earnings" (principle #2 in picture 4).

A: Worst case, it destroys value!

This is especially vital with regards to acquisitions as these transactions can create and destroy Shareholder value so much faster than the day-to-day grinding of the normal operations. When informing the market about a deal bankers and CEOs generally like to state that the acquisition will be "earnings accretive", i.e. that the corporate EPS will increase due to the transaction.

Earnings accretion tells you nothing

The thing is, any acquisition of a target company that has a lower PE-ratio than the acquirer will be earnings accretive (and vice versa). But not all companies with a lower PE-ratio than your own are undervalued - they could even be overvalued if they in fact deserve to have an even lower multiple.

Earnings accretion says very little about value creation since it ignores that differences in ROE-levels, growth opportunities and risk levels should award companies varying PE-multiples. The discussion of earnings accretion is plain stupid and hence principle #3 in picture 4 says "make acquisitions that maximize expected value, even at the expense of lowering near-term earnings".

Portfolio management

Despite the best efforts of a capable CEO and the wise governance of the board, specific business areas have different opportunities to create value within different corporate environments - simply because the environment itself will affect the ability to generate cash flows. This means that the value of a business depends on which corporate home it has.

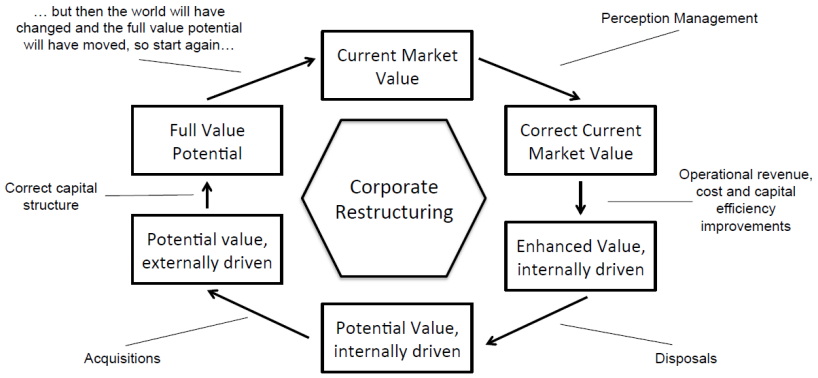
The best corporate owner of a business will be the one that enables a maximization of the discounted present value of the free cash flow streams that can be generated from the assets. Some companies add value to the underlying business by linkages with other activities or resources under their corporate umbrella. This could be allowing a promising new product access to an already established sales network, merging the production for a business with factory underutilization with one that operates on more than full capacity etc.

Are you the best owner?

Consequently, value is created when the resources tied up in businesses are owned by the most suitable, value creating corporate environment for that specific type of business. Simply because a business can have different value for different corporate owners this gives a rationale for an active portfolio handling within companies leading to disposals and acquisitions.

The board should continuously question the current set up of the business portfolio within the company and be able to articulate why their company is the best owner of the underlying units – or as #4 in picture 4 says "carry only assets that maximize value". At the same time corporate business portfolios mustn't have too high turnover rate as the underlying units need some amount of stable conditions to function properly to create value – it's a balance.

Picture 16. Corporate Restructuring Hexagon



Source: The author, inspiration McKinsey

Plenty to do

The picture above describes a number of activities to manage the value of a company. It covers topics like the internally handled efforts to increase cost and capital efficiencies and grow revenues, the adjustments to achieve a correct capital structure plus the business portfolio handling through disposals and acquisitions of units.

Investor communication – align price with value

The additional component in the picture is "perception management" which has a slightly cynical ring to it. The task is however not to unduly pump up the current share price as this neither builds value in the company nor benefits the Shareholder (only a currently selling shareholder at the expense of another currently buying shareholder). The task is instead to try to make sure that the price and the estimated fair value are aligned as far as it is possible by supplying investors' high quality information. With this we turn to investor communication.

Communication Goes Two Ways

"*In large parts, companies obtain the shareholder constituency that they seek and deserve*." /Warren Buffett

Focus on building value and the price will follow

The share price is set by the interpretation of the value of the company as judged by the marginal buyers and sellers on the stock market. The company should focus on creating Shareholder value and communicating what they are doing on the premise that the share price will eventually follow. From this also partly follows what not to do.

To temporarily fudge the external picture of earnings does hardly create value

In picture 4 in the above introduction principle #1 says "*Do not manage earnings or provide earnings guidance*". That companies should refrain from earnings management is fairly obvious from the perspective of the Shareholder – it's not value enhancing for the owners as a collective over time to temporarily fudge the perception of profits. Even though it could be value enhancing for the trader who manages to sell at a too high price and value

destroying for the unfortunate buyer in this transaction, it is hardly the task of the company to prioritize one (potentially more short-term) owner over another.

Picture 17. You Can Fool Some of the People Some of the Time…

Source: Working Capital Review

The task is not to boost share price…

Some companies might object that if they smooth out and shield the investors from some of the short-term volatility in the business this apparent stability will support a higher share price. Yes it could – for a while – but first of all, the task of the company is not to boost the temporary share price, it is to build Shareholder value in the business and then the share price will follow over time.

…and it's not very flattering

Secondly, it would be to purposely communicate an untrue picture of the company. This in a way infers a view that investors are stupid and managers are smart. Companies that engage in this game instead implicitly say something about their priorities and the signal to the important fundamental value investor is to "stay away".

A slippery slope

Lastly, these attempts way too often end in a destructive spiral. The practice of withholding some profits a good quarter to be able to prop up the coming weaker quarterly earnings builds on a zig-zag pattern that now and then doesn't repeat. If a company for example stretches its balance sheet to be able to make up for a poor quarter and hopes to make it up in the next quarter, it is implicitly betting on that the results will improve short-term.

If the poor trend instead is prolonged the profits will eventually have to be adjusted to reality in a much more violent way that probably will result in

profit warnings, possible losses, media headlines and potential management dismissals – even for the CEO without moral objections to earnings management, is the gamble of the practice worth it? We think it's clearly not.

Picture 18. Zig Zagging too Close to the Edge

Fancy a dive?

Source: Benzinga.com

What! No guidance?

Refraining from earnings management isn't really a controversial view on the stock market. To encourage companies not to give earnings guidance is another matter. Many investors are of the view that more information is always better and as managers sit on inside knowledge they should be able to help investors in forming their expectations of the future by providing guidance – for example regarding the expected EPS the coming year or quarter.

They don't know…

The thing is that even with access to inside information academic research shows that corporate managers don't have access to an especially transparent crystal ball. They are on average systematically overoptimistic and quite often get their predictions way wrong. There lies no derogatory opinion in this statement as the future is unknown to us all.

…but get boxed in to deliver

The problem is that by giving explicit guidance the management has placed some of its credibility on the line with regards to actually delivering on the numbers and analysts' consensus estimates will inevitably form somewhere very close to the guidance. As the guidance from time to time will turn out to be too optimistic the temptation for earnings management will come creeping for some less scrupulous managers, with the vain hope of bridging the slump and make up for it later. And if the slump lasts longer than expected? Well, we're now back to the same vicious spiral as described above due to the unintended consequences of giving guidance.

Unilever with the chairman Michael Treschow is one company that has stopped giving forecasts. They have also moved to only giving semi-annual reports. Does this mean companies shouldn't give much investor information at all and let the results speak for themselves? We think not.

Help the market

Investor communication is about facilitating research that can help the market to set a price reasonably aligned to a fair intrinsic value of the company. Looking at academic research there is actually some indications that short-term investors gravitate towards companies that issue plenty of short-term oriented information to trade around.

Give information that matter for long-term oriented owners

If a company thinks that investor short-termism is a problem for them this actually offers an opportunity. All investors are owners of the company and have the right to equal and fair treatment and access to information. However, there is nothing that prevents a company from tailoring its information to better suit the longer term investors. Perhaps this over time will gradually shift the mix of the shareholder base towards more of the fundamentally inclined kind.

This throws up an interesting discussion if it is passable for a board to try to adjust the composition of its ownership base when the owners are the principals of the board itself? We think so. If we accept the notion that the board director is the trustee of the Shareholder instead of the shareholder, in line with the discussion above, then the board actually should tailor its information to suit the active long-term investor.

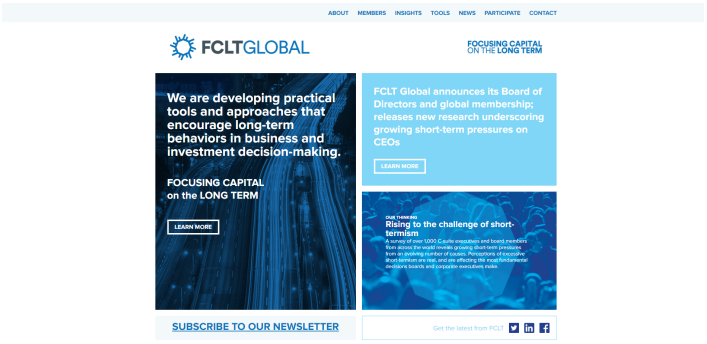
Build barriers-to-entry and discuss the progress…

Companies that target fundamental long-term investors will naturally focus on the information that matters for them. Topics like strengthening or weakening of barriers-to-entry for competition, the developing of competitive advantages, corporate strategies, pricing power, market share movements, investment cycles, long historic trends and future aspirations for return on capital levels and the underlying ways to reach these - including targets for through the cycle margins, capital usage and growth and so on become way more important than commenting on short-term FX fluctuations and massaging quarterly analyst consensus EPS expectations.

…and the disappointments

When the realities of the corporate development at times disappoint, as it always does, it is important for the long-term investor with candid timely information on what has happened and what is being done to change the situation. Principle #10 in picture 4 says “provide investors with value-relevant information.”

Picture 19. Focusing Capital On The Long Term Website



Source: fcltglobal.org

Budding initiatives…

The organization Focusing Capital on the Long Term "*dedicated to developing practical tools and approaches that encourage long-term behaviors in business and investment decision-making*" has issued a number of white papers instructing corporations on how to structure their communication to improve the communication with their longer-term owners.

…with strong backers

FCLT began in 2013 as an initiative of the Canada Pension Plan Investment Board and McKinsey & Company, which, together with BlackRock, The Dow Chemical Company and Tata Sons, founded FCLT Global in July 2016. Since then a number of members have joined including Dutch APG and PGGM, Danish ATP, CIC from Singapore, Canadian Ontario Teachers' and La Caisse de dépôt et placement du Québec and several others.

Two-way communication

An investor relation is a two-way communication where executives and potentially directors should listen to investors as well as presenting their company. We would actually advocate companies to build relationships with some of their longer term oriented investors – not simply because they are some of the owners of the company but since they can contribute insights. Also, candid two-way communication builds trust and who knows when the company will need the support of its owners? - Activists might show up on the doorstep or the company could need a capital injection.

As a side note, it is probably not a bad idea if investor relations departments or strategy departments in companies made their own reversed DCFs, discounted cash flows, to try to interpret which view of the company's long-term value creation that is priced by the share price. However, be careful not to read more into the numbers than what is there. The stock market pricing also factors in large amounts of macro factors and crowd psychology.

Try to get some corporate benefit from investor meetings

In investor meetings executive managers should in our view prioritize long-term fundamental investors and delegate contacts with other investors to the IR department. Let's not forget that the investors that perform in depth research on companies potentially sit on information and insights around industry dynamics, corporate strategies or even the state of the economy that could benefit the company.

Investors are served by a number of investment banks and their – sometimes global – research departments that regularly surveil industry developments. Often the corporate IR-departments also receive such research but it cannot hurt to discuss with another party that collects and digests the market research data from such a large number of sources.

Who are the owners?

To facilitate a constructive dialogue, companies should try to categorize their owners. Again, there cannot be any preferential treatment in what information is provided but companies can have as a strategy to comment as little as possible on what interests one type of investors and be generous in what they provide in terms of information that suits another type.

The trustee should get to talk to the principal

Today, the CEO and the CFO of Swedish companies tend to meet with investors – present shareholders or not. However, direct communication between board directors and owners rarely happens today. Some CEOs almost seem to be unsure if the board directors are knowledgeable enough to face investors/the owners and it would also create a communication channel that they would have trouble overviewing. Internationally, the chairman of the board has a much more extrovert role communicating both with media and with investors.

Not a walk in the park

Our view is that some director-owner communication would be beneficial for the board work. However, it would probably require the current rules of procedure for the board to be amended, the communication must be coordinated and above all the directors must be drilled by the IR-department on what they can say or not to ensure a consistent message from the company. It would also be important that all parties understood the format of such meetings so that the investor representatives don't try to tease marginal short-term information from directors who probably cannot answer such questions anyway – this would make all parties disappointed.

There is current communication

We don't want to convey a message that directors never meet with owners and discuss business related issues. There are occasional meetings, dinners in a few companies and in times of media storms or other crisis situations it is not unusual that owners are called to or demand a discussion with the chairman present. Further, to some extent strategic issues could be discussed in relation to the board evaluation in the nomination committee even though it isn't really the time or place. Related, some companies now and then invite sell-side analysts to board meetings to present the analyst's view of the company and the market.

Not unnatural some CEOs also think that passive owners is quite comfortable to have since the CEO then has more of a free hand to run the company by his own. For them the entire topic of this text is challenging their sovereign position. We view this as misguided.

Change requires some effort and adaptation

In a SNS report Conor Koher, head of McKinsey's European private equity practice, urges owners and board members to engage themselves more in the strategic work of the company: "The executive management will appreciate it, even if they will be irritated at first."

Stewardship Codes 2.0

To perform well you need to know what to do

Without a clear assignment it's hard to be effective in performing any role. This applies to board directors as to anybody else. The interface between the board and the CEO/executive management is relatively well structured while the interface between the owners and the board is not, at least not outside the AGM and with regards to strategic governance. With a major investor with a board seat the intentions of the owners become more transparent. In companies that lack such an owner some other function will have to make up for the absence of clarity.

The problem is that any of the many smaller owners will have different opinions as they have different investment strategies and benefit from different actions. It also takes time and resources to engage with companies and the activity benefits all owners creating a free-rider problem reducing the will to engage in strategic governance issues. There isn't any natural representative for the Shareholder.

Swedes are up to it

Still, many of the larger Swedish owners of Swedish companies are fundamental investors that are holding reasonably concentrated portfolios and as a collective they will be the owner of the Swedish companies for the foreseeable future. Even individually they are often large enough to be exposed towards the same companies for long times and as the saying goes "if you can't sell, you must care". Further, the ownership chains in Sweden are relatively short with less of investment consultants, fund-of-funds etc. and many pension funds and insurance companies manage their own portfolios in-house.

Need a mandate

In some way institutional owners have gained power without seeking it. Their primary aim is to generate returns for the savers that have entrusted them with their money and in the process they, as a middle hand, became so large asset managers that it is now hard for the institutions to duck for the responsibility as an owner. To do this their mandate from the savers, who are the general public in aggregate, must perhaps be made clearer. Since a well-functioning economy is vital for the population of a country, we don't think that a mandate for strategic governance is out of place.

Lack of resources…

One main problem for the institutional asset management firm is insufficient resources. Seeking fundamental information and engaging in the strategic governance of companies is in some ways to contribute to a public good as it improves the capital allocation of society and by this its wealth. Delivering risk capital is a commodity, especially in a world that is overflowing with liquidity, but assisting companies so that they can reach an operational excellence and a strategic foresight that gives them competitive advantages is a capacity in short supply.

…so a low budget solution would be nice!

It is never the less a practice that costs money. As such there is some theoretical ground for giving advantages by some measure to those who perform this more active role over other investors who only supply risk capital. Still, without such advantaged treatment few asset managers can today charge an extra fee for handling strategic governance. Cheap solutions are therefore critical.

Stewardship code – expresses how an owner sees best practices with regards to strategic governance

Below we present our suggestion to how long-term fundamentally oriented institutional investors that apart from being portfolio managers of securities also view themselves as part owners of companies, could formulate an ownership declaration - or stewardship code as it has come to be called - meant to benefit all owners over time. It wouldn't cost much and hopefully the practice can give directors some guidance of what benefits the Shareholder and by this to some extent liberate the company from the stock market's more short-term behavior.

High abstraction but still usable

Any such stewardship code will have to be kept in principled terms or else the owner risks treading on the toes of the board. The task is to keep the thoughts on a relatively high abstraction level without risking to make what is said watered down and unusable. The aim is to create Shareholder value and all companies face a different business environment in which they operate – still there are useful generalizations to be made.

In the picture below we present the principles of the UK Stewardship Code. This is what we would call a stewardship code 1.0.

Picture 20. Principles of the UK Stewardship Code

This is all very nice but…

So as to protect and enhance the value that accrues to the ultimate beneficiary, institutional investors should:

1. publicly disclose their policy on how they will discharge their stewardship responsibilities.
2. have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed.
3. monitor their investee companies.
4. establish clear guidelines on when and how they will escalate their stewardship activities.
5. be willing to act collectively with other investors where appropriate.
6. have a clear policy on voting and disclosure of voting activity.
7. report periodically on their stewardship and voting activities.

Source: The UK Stewardship Code, September 2012, Financial Reporting Council

…it will not guide directors

Honestly, investors following this will probably give no guidance to directors what so ever when it comes to a company's strategic governance. As all too usual within corporate governance – and despite "enhancing value" being mentioned in the introductory line - the focus is on ticking boxes with regards to processes and mechanisms instead of formulating practical principles on value creation. Statements under principle number one could potentially contain some useful information, but probably not.

Because of this it's a shame that the UK Stewardship Code has become the template for the many subsequent codes internationally. In many companies there is an ownership vacuum. We need higher quality engagement; what we need is a stewardship code 2.0.

https://www.vontobel.com/CH/Download?Source=AssetStore&Id=5b649e02-d18a-4834-ab6f-828f79016768&Filename=The_Hermes_Ownership_Principles_EU.pdf

UK Hermes Investment Management is an example of a firm that has written what we would call a stewardship code 2.0 with its *The Hermes Principles: What shareholders expect of public companies – and what companies should expect of their investors*. If the UK could export Hermes principles instead of its UK Stewardship Code much would be achieved.

Easier triangulation than you think

Isn't there a risk that if all institutional investors wrote their stewardship codes these would all point in very different directions and board directors would be none the wiser? There will surely be some differences, but our guess would be that codes written in general terms by fundamental long-term investors would look reasonably similar and in aggregate would deliver a very clear sense of direction for directors. We would also guess that more short-term investors wouldn't write stewardship codes at all.

Joining forces?

Our initial thought on the topic was that each institutional owner would write their own code. However, as the wording is kept on a general level we see few obstacles for cooperation among several institutions as this would both increase the importance of the text and also aid the corporate understanding of what owners want. Who knows? In the end we could even end up with a joint Swedish effort that most financial institutions back up?

Such a joint effort would require some administrative coordination but if completed, it would also be reasonable to then ask that the chairmen of the boards of the Swedish listed companies to read the stewardship code and sign off that they indeed have read and understood it. There would be no consequences if the board subsequently behaved differently but just the procedure of signing something could foster better alignment between owners and boards.

Such an initiative would, due to its voluntary nature and focus on the owners view on strategic governance, probably be better administered through the IÄF (Institutional Owners Association, Institutionella Ägarnas Förening), an association including the 14 largest institutional shareholders in Sweden.

Taking a step back

The joint stewardship code could also complement the rest of the material in relation to the annual strategy sessions of the board. Exactly because it contains best practice business behavior for creating Shareholder value and not focuses on the current pressing issues at hand it could aid boards in taking a step back and challenge their present view.

Take it for what it is

We absolutely don't want to paint an excessive and romanticized picture that owners know better or even know as much as the board directors on issues related to business strategies. We would also argue that the Swedish institutional owners never really have managed to work out a structured joint view of how they want to structure incentive programs. However, we would argue that the cynic director's doubt that they cannot contribute at all is wrong. And as the director is the trustee of the owner it is in some way in his interest to receive input from the owners.

A middle way

What follows on the next page is our draft proposal on a generic funds stewardship code 2.0 for a single institutional owner. Our hope is that a code like this could help to make clear what the Shareholder benefits from in the cases when there isn't any major owner with board seats in the company. You cannot force minority owners to act as if they were large owners, there has to be some sort of middle way and publicized strategic governance stewardship codes is in our view a cost efficient alternative.

STEWARDSHIP CODE

Purpose of the Code

This document aims to describe the fund's ambition and opinions as an owner in listed Swedish companies. The target audience is our employees plus board directors and CEOs of the listed companies where we are owners. The ambition is to improve the dialogue between the fund as an owner and the companies where we are a part owner and by this hopefully increase the value of the companies. As a long-term owner we view it as our responsibility to influence the companies we own in a way that benefits our clients.

The fund neither has the resources nor the intention to regularly engage in the specific strategic decisions of the individual companies in which we are owners. This is the task of the corporate board. In this code we instead present our principle view in general terms. There could be a number of situations where the specific circumstances invalidate these general statements. Should board directors wish clarifications with regards to the content of the code we welcome the discussion but we generally do not have resources to act as a strategic advisor in particular situations and also don't want to be made insiders on a regular basis.

The code has a value if it serves the purpose of making it more transparent which business practices and strategic choices we support and which ambition level the fund can be expected to have in this area. Further, the code gives the public, media, politicians and other interested parties a view of our position on the below topics. The Stewardship Code should be read in conjunction with the fund's ownership policy and our CSR policy for a more complete picture of our ownership engagement.

Long-Term Shareholder Value

Our starting point is that companies should work to create long-term shareholder value and that this is not in conflict with sustainable value creation for other stakeholders in the company. When companies seek to create long-term shareholder value and the capital market allocates resources to areas with higher returns, and away from those with lower, this enables the scarce resources of society to be utilized to their largest benefit for the society's inhabitants. Your primary task as a board member is to make the company more valuable for its owners.

The shareholder receives the residual cash flow that is left after all the other stakeholders have received their compensation. No company can in the long run unduly exploit any of its stakeholders in a society where there is free choice as those unfairly treated will simply chose not to engage with the company. As a company depends on all its stakeholders this would destroy shareholder value.

Long-term really means long-term and not the current or next quarter or year. Maximizing shareholder value is not equivalent to maximizing near-term earnings or current share price. As an owner we don't want you as a company to sub-optimize on our account and by this make choices that sacrifice long-term value creation to look artificially positive in the short-term. Of course, this is not a carte blanche to spend money casually today on the vane hope of recouping poorly invested money in the future.

Return on Capital

Companies with a higher return on invested capital than the cost for the capital create value for their shareholders when they make investments. A higher return on capital comes from higher profit margins and/or a more efficient capital usage. A sustainably high level of return on capital over the long-term is always better for the value creation than a lower. Apart from the industry structure the development of competitive advantages will be among the factors that most allow the return on capital to stay high over time.

Since most business decisions entail a balance between various drivers of value it is important for companies to understand each value driver's relative weight for them specifically. A company with low return on capital will in general create more value through higher profit margins and more efficient capital usage than from efforts to increase growth rates. The opposite is normally true for a company with already high return on capital.

Companies should look to the absolute value creation in monetary terms. In principle companies should invest in new business projects as long as the expected future return on capital is higher than the cost of capital irrespective of whether if the new project lowers current levels of return on capital. In reality there is a tradeoff as the marginal return on projects tends to be declining and as the access to capital isn't unlimited.

Organic Growth

Organic growth in sales or in invested capital can both create and destroy long-term shareholder value. When a company's return on capital is higher than its cost of capital an increased organic growth rate generally improves its shareholder value creation. When the return on capital is lower than its cost of capital an increased organic growth rate generally destroys value.

There could be situations where growth leads to for example higher capacity utilization that in itself increases the return on capital to create value. However, in highly competitive industries or in companies with unproven business models the focus should generally be to improve the profitability first and to only grow later when and if earnings have improved.

Keeping a high organic sales growth rate over a long period of time is normally harder than sustaining a high return on capital. Different types of organic growth often vary in their sustainability. How sustainable a growth rate is often depends on whether it is created at the expense of customers that can leave the company or of competitors that can retaliate. Hence, in most cases we would caution companies from growth created by for example price reductions, heavy passing promotions or temporary spikes in marketing.

Risk Management

Risk can be operational or financial. In this paragraph, Risk Management, we address the first while the latter is addressed under Capital Structure.

One task for a company that has created shareholder value through its operations is to make sure that it doesn't squander this value by taking undue risks. At the same time companies must take calculated risks to stay in business so the key is to decide on which risks one should take and which one should avoid. Hence, risk management is one of the most important tasks for the board.

There are different types of risk. These different risks lay on a scale where some are frequently occurring and reasonably easy to quantify and others are infrequent, hard to quantify but could have grave consequences if they come about. The first type of risks is the domain of operational processes run by executive management. They can generally be managed although this might entail some costs.

The management of the second type of more unquantifiable risks will benefit from the experience, intuition and wisdom of a well composed board of directors. In a business environment that often is changing in an increasing pace, corporate survival will depend on acquiring knowledge of the company's environment, gaining optionality in choosing different paths and having an organization that culturally can be flexible enough to respond to environmental changes.

Capital Structure

Capital structure deals with the financing of corporations but also with the capital allocation between businesses within corporations. On the corporate level it is vital that the capital structure allows a company to execute on its strategic plan and at the same time has the ability to withstand the economic downturns that eventually will appear.

The base rule is that companies should retain the cash flow and capital they internally can invest at a higher return on capital than the required cost of capital of the capital markets - and distribute the rest to the owner. An efficient capital structure will handle the balance of the operational risk and the financial risk. A company with high operational leverage and volatile sales trends should normally have lower financial leverage and vice versa.

That said, the capital structure should be effective but it is important to keep the optionality of available resources to be able to make acquisitions or investments in bad times. It is often in these situations that the market positions of a company can move substantially. A slightly too low leverage from a theoretical standpoint will lower returns on capital somewhat in normal times but provides an option value in bad times. A too high leverage will increase return on capital somewhat in normal times but could mean massive value destruction in bad.

To generate a high sustainably return on capital a company must be efficient in its usage of working capital and capital expenditures and yet be willing to invest in future value creating opportunities. An often underappreciated way of using capital more efficiently is to be more active in allocating capital between the various businesses within a corporation according to their value creating potential. In allocating resources companies should differentiate the cost of capital depending on the risk level of a business.

The Business Portfolio

A company often consists of a portfolio of different businesses. The best corporate owner of such a business is the one that will create the most future cash flow from owning it. The future cash flow stream and by this the value of a business will differ due to various connections to other businesses in the company's portfolio. Hence, when analyzing the business portfolio it is vital to understand the synergies between the many underlying businesses.

Since different companies differ in their suitability as an owner of an underlying business there is a rationale for an active portfolio management process purchasing and exiting businesses. CEOs and boards should scan the market for businesses where they are a better owner than the current and also periodically review the businesses they already own. In this one must proceed with caution. Businesses need a stable environment to flourish and a company without a firm core can lose its identity.

This active portfolio management doesn't mean that a business that performs less well must be sold. It all depends on which alternative that creates the most value. If it's possible to turn the business around to motivate its position in the portfolio, or command a higher price in a later sale, this could obviously be a good investment decision to make.

Mergers and Acquisitions

We prefer organic growth over growth from acquisitions. The latter is bought with the shareholders money and on average acquiring companies has historically overpaid for the target companies. We generally prefer small acquisitions by experienced acquirers in fragmented sectors where there could be developing scale advantages over the opposite. Further, our view is that acquisitions made in auction situations too often come at too steep a price.

The attractiveness of a deal in the end comes down to the price of the acquisition. Reasonably priced acquisitions are more often done in less buoyant parts of the economic cycle. An acquisition does not create value for the target company's shareholders simply because it is so-called earnings accretive. Neither does it destroy value. Earnings accretion is simply not a relevant measure with regards to the value creation of mergers and acquisitions.

An acquisition creates value if the future cash flow from the two combined companies is higher than the sum of the future cash flow from the two separate companies. Depending on the acquisition price this created synergy value will pass to the owners of the acquiring company, the target company or both. In the case were a listed target company's share price correctly mirrors the company's intrinsic value the value that passes to the acquiring company's owners will be the synergy value minus the bid premium.

Investor Communication

Corporate insiders should not focus on managing the current share price. Company insiders should concentrate on creating long-term shareholder value and communicating what they are doing in this respect on the premise that the share price will eventually follow. The task of the investor communication is not to increase the share price; it is to provide a sufficient amount of relevant information so that investors can form a well-informed view of the intrinsic value of the company, without harming the value creation by releasing competitively sensitive information.

The information must be honest and objective in both good and bad times. All investors have the right to the same information but that doesn't mean that all investors are entitled to all the information they want. The information supplied should in our view concentrate on the long-term fundamental prospects of the company.

Communication is an exchange of information and in this respect it is our view that the communication should go two-ways. Companies can benefit from building up a relation with sophisticated fundamental investors and analysts that understand the company and its market in depth as they often sit on knowledge and can be valuable speaking partners.

Wrap Up

What do they want?

Board directors are the trustees of a company's owners and should work for their benefit. Still, in companies with a dispersed set of institutional owners that lack a major shareholder with a board seat it is hard for directors to know what that benefit actually implies – it is hard to know what the owners want out of their trustees. In this text we wanted to dissolve the mist around the question.

Who are they to start with?

Unfortunately, as we showed there are a number of very different types of investors and they want different things. We further tried to give board directors an insight into how their different actions shape the movement of stock market prices and aimed to debunk the perception of a short sighted market - or at least make the discussion on the market participants' horizon more nuanced.

Serve the Shareholder

To solve the Gordian knot of knowing what such a diverse set of owners want we presented the concept of the Shareholder with a capital S - the aggregate of all shareholders for all eternity - and suggested that the board director really should view himself as the trustee of this aggregate Shareholder. The collective Shareholder cannot sell the company's shares and by this is extremely long-term oriented. The benefit that the board director should work for is to create Shareholder value.

Build value and discuss how you do it

We tried to show that the generation of Shareholder value not only is the primary task of the board but also is a very practical day-to-day business concept that doesn't conflict with the interests of other stakeholders. We argued that the perception that owners in general benefit from the maximization of the current profits or share prices and that this equals value creation for the Shareholders is wrong. It is further the task of the company to inform investors of the value creating work they do so that they can form well formulated opinions of the value of it.

Finally, we advocated an increased two-way communication between the board and fundamental long-term owners as well as a re-direction of the corporate investor communication overall to better suit long-term investors and by this help them price the stock closer to a reasonable intrinsic value.

Stewardship code 2.0 as a way to bridge the information gap…

The text ended with a suggestion for institutional investors to publish a stewardship code 2.0 that would develop their corporate governance role in a more business oriented direction. Such codes would hopefully give board directors and CEOs a better picture of what the Shareholder requires of the company's board directors and executive managers and by this bridge the information gap when there is no major shareholder with a board seat.

In a recent McKinsey-report we noticed that the CEO of BlackRock, Larry Fink, has sent a letter to all S&P 500 CEOs urging them to have "consistent and sustained engagement" with their shareholders and Bill McNabb, the CEO of Vanguard, has encouraged boards to communicate with shareholders through

for example a shareholder liaison committee.

… and a good start

Further, Mary Jo White, the chair of SEC, has stated that "The board director is – or ought to be – a central player in shareholder engagement". In our view, openness from boards to engage in communication with owners that in turn share their view on strategic corporate governance through a stewardship code 2.0 will go a long way.

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Not all board directors, CEOs or institutional shareholders will agree with everything we have written in this text. We are happy to discuss the topic further and truly appreciate all feedback. Send us an e-mail.

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Mats Larsson, October 10, 2018