Introduction

Good corporate governance, according to modern views expressed in various corporate governance code, suggests that shareholders fully participate in the decision-making process at general meetings. It is in the company’s interest to have as many shareholders as possible take part in this process. Moreover, the general meeting must be able to exercise such influence on the policy pursued by the board that it can play a full role in the system of “checks and balances” in the company (see for example principle IV.1 of the Dutch Corporate Governance Code).

These two elements, active involvement of shareholders in decision-making and relevant influence of the general meeting on the policy pursued by the company’s board, are key in modern thinking on corporate governance. Traditionally, they have also been basic premises in company law: the general meeting has important core powers, and shareholders are entitled to vote at the general meeting. Historically for non-listed companies, these premises are based on the development of the company from a contract-based partnership. Partners became shareholders of a company which often still "felt" like a contract between them. The contractual basis was perceived to continue in the company and this made it logical for shareholders, essentially as contractual parties, to exercise final control.

In company law, often there has not been a strong distinction between listed and non-listed companies. However, the contractual approach to the company is under pressure in listed companies where shareholders are often far removed from the company and its affairs and are much more investors than shareholders. An institutional view of the company has developed mainly with the listed company in mind. In the Netherlands, this institutional view went as far as to limit to a considerable extent the rights of the general meeting as well as those of individual shareholders, leading to a Dutch discount on the valuation of Dutch companies. In the course of the 1990s a counter movement started, advocating that good governance required a relevant position of shareholders in the
company. The history of the listed company, with its roots in the Dutch East India Company as the first publicly traded company in the world, was being remembered. A strong shareholders position is needed to counterbalance potentially excessive power of directors, a lesson learnt by the Dolerende Participanten (Complaining Shareholders) of the East India Company at the time. ¹ This idea was given new support by modern economic theory. In the economic theory on the agency conflict, the shareholders are “residual claimants”, those who bear the ultimate economic risk of the enterprise and only receive a return after all creditors have been paid. As residual claimants, shareholders have the best incentive to take decisions about the company’s objective and strategy.² It is up to them, as principals, to discipline the directors, as agents. In listed companies too, the shareholders should therefore have core powers enabling them to discipline managers. The idea of shareholders as residual claimants also implies that shareholders should have individual voting rights in proportion to their participation in the risk-bearing capital of the company. The High Level Group based its advice on the Takeover Directive in 2002 on this “proportionality principle”. It has led to an extensive debate in the European Union on proportionality as a core principle in our company laws, commonly referred to as “one share one vote”.³ In the Netherlands, this has led, among other things, to the best practice provision in the Corporate Governance Code that the voting rights attaching to financing preference shares should be based on the fair value of the capital contribution (provision IV.1.2).

History shows that the basic assumptions and concepts of shareholder involvement and voting may have an old basis, but reality is a lot more frayed. They have rarely been applied in a strict way but consistently form the subject of public and sometimes political debate on how much listed companies should be exposed to the whims of the capital market on the one hand and the power of the company’s management on the other. Both operate to some extent as communicating vessels: a strong position of the company’s management is often a way to limit the company’s exposure to the capital market. The debate sometimes swings this way and then the other. Surged on by the governance debate and market confidence, the rights of the general meeting and those of individual

² F.J. Easterbrook, D.R. Fischel, The Economic Structure of Corporate Law, Harvard University Press 1991, p. 67-70. Easterbrook and Fischel do recognise the fact that in the case of insolvency creditors become the residual claimants and obtain decision-making powers that rank above those of shareholders. Moreover, creditors are residual claimants to some extent in important transactions, such as legal merges and repayment of capital to shareholders, and are specifically protected in those situations.
shareholders were extended, one may say restored, in the Netherlands in 2004. But the recent crisis has already raised the question whether this has gone too far and whether companies should be given more protection against the short-sighted pressures of the capital market. In 2008 a new provision was included in the Governance Code introducing a response time of up to six months that the managing board can stipulate if shareholders want to discuss the company’s strategy, during which period shareholders are not supposed to force decisions on for example the board’s composition (II.1.9 and IV.4.4). This is a new example of protecting the company’s management in order to reduce the company’s vulnerability to the capital market.

Institutional investment

Where meaningful shareholder engagement in listed companies is concerned, we should mainly look at institutional investors. They hold most of the capital of listed companies: around $71.3 trillion across the globe in 2009. Institutional investors come in different forms and sizes: pension funds (holding $28 trillion in 2009), insurance companies ($20.4 trillion), traditional investment funds ($22.9 trillion), alternative investment or hedge funds ($1.7 trillion), sovereign wealth funds ($3.8 trillion), private equity funds ($2.5 trillion), Exchange Traded Funds (ETFs) ($1.0 trillion) and so on. Their investment categories and strategies can vary greatly, but where they invest in shares in listed companies there is a notable trend: portfolio diversification. The idea is that a more widely spread portfolio results in risk distribution and therefore risk reduction. David F. Swensen, the successful investment officer of Yale University, puts it as follows:

“At a given risk level, properly diversified portfolios provide higher returns than less well-diversified portfolios. Conversely, through appropriate diversification, a given level of returns can be achieved at lower risk. Harry Markowitz, pioneer of modern portfolio theory, maintains that portfolio diversification provides investors with a “free lunch”, since risk can be reduced without sacrificing expected return.”

I always believed that economists thought that “there ain’t no such thing as a free lunch”. There is also criticism of the Modern Portfolio Theory, which provides a mathematical forecast of expected returns, on the basis of historical trading data. Reality tends to be different from mathematical models that ignore personal, environmental, strategic and social dimensions of investment decisions and factors that may prevent the market from

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working efficiently\(^6\). Nevertheless, the Modern Portfolio Theory has taken root in the investment world and has become the norm for many institutional investors. The American Uniform Prudent Investor Act of 1995, which imposes principles of prudent asset management on asset managers, requires that investment decisions are not taken in isolation but in the context of the portfolio as a whole and that an institutional investor should diversify its investments unless, in special circumstances, the object of the fund is better served by not diversifying.\(^7\) The European Pension Directive likewise requires pension funds to pursue an investment policy that is in line with the “prudent person” rule, which entails that the security, quality, liquidity, and profitability of the portfolio as a whole is to be safeguarded and the assets should be properly diversified so that an excessive reliance on (or confidence in) certain assets or a particular issuer or group of undertakings and risk accumulation in the portfolio are avoided (article 18 of Directive 2003/41/EC). Similarly, the European Solvency II Directive requires of insurance companies that they invest in accordance with the prudent person rule and achieve sufficient diversification (art. 132 paragraph 4 of Directive 2009/138/EC.

Modern Portfolio Theory diverts the investor’s attention away from the choice of individual shares to the composition of the portfolio as a whole.\(^8\) The attention is entirely focused on mathematical insights into the relative performance of shares and investment funds in relation to selected benchmarks or indices, reflected in alpha (the return of a portfolio or an investment fund above the return of the market or a benchmark) and beta (the sensitivity to fluctuations in returns on shares or investment funds in comparison with the sensitivity of the market or benchmark). Investment decisions are taken on the basis of these types of mathematical calculations based on historical data. Insufficient diversification is seen as an increased risk in the portfolio as a whole for which the investor is not compensated. An investor must therefore ensure that his portfolio is an adequate reflection of the market, for example as reflected by indices.\(^9\) And institutional investors have done this in large numbers. The huge Norwegian state fund Norges Bank invests in 8,300 listed companies worldwide,\(^10\) the Californian pension fund Calpers invests in more than 7,700 companies, and the Dutch pension fund managers APG and PGGM each invest in more than 4,000 listed companies.

This practice of, what I would call, extreme diversification has a significant impact on the taking of investment decisions by institutional investors. They sell or buy shares in companies on the basis of their weighting in an index. Index trackers want to follow a share index exactly and are, apart from adjustments to the index that force them to buy or

\(^8\) Maatman, op cit, p. 228-229.
\(^9\) Maatman, op cit, p. 233.
\(^10\) Het Financieele Dagblad 8 November 2010.
sell, completely passive. Others are *overweight* or *underweight* in relation to the index or their own model portfolio that they have created on the basis of assumptions about price trends, or become overweight or underweight by price trends which force them to sell or buy. Within the model portfolio there is a constant search for investments which are expected to yield higher returns in the coming period than other investments. Existing investments are constantly compared with potential investments and sold when more is expected from potential investments. This leads to constant buying and selling of shares and calibrating of the portfolio. Davis, Lukomnik and Pitt-Watson wrote in 2006 that the investment industry annually wastes an amount of about $100 billion in excessive fees, unnecessary trading and poorly executed transactions.\(^{11}\) As a result, in the US the average period in which a share is held by the same shareholder has fallen from 57.1 months in 1980 to 4.8 months in 2009.\(^{12}\) For the constant trading liquidity is crucial: “Market players seek liquid positions, allowing immediate disposition of yesterday’s loser and rapid acquisition of today’s hot prospect,” according to Swensen.\(^{13}\) A manifestation of the need to be able to buy and sell at any time is the resistance of institutional investors to the blocking of shares for a number of days in order to be able to vote at the general meeting. The European ban on share blocking in article 7 paragraph 1 of Directive 2007/36/EC on Shareholder Rights is a result of this resistance.

The knowledge and expertise institutional investors need in order to be able invest in this way is mainly related to the market and only to a limited extent to individual companies and their long-term prospects. Information about individual companies consists only of publicly available data, often supplied by *sell-side* analysts or brokers. There is usually no in-depth insight into the prospects and risks of individual companies, nor a real interest in the governance of those companies.

**Intermediation**

This trend is reinforced by another development. We are seeing more and more intermediation on the capital markets as asset managers take over investment decisions from investors. Not only retail investors but also increasingly institutional investors outsource their investments to asset managers. For smaller pension funds it is often impossible to have sufficient knowledge in house to make investment decisions themselves. But larger institutional investors too increasingly turn to asset managers who invest various parts of their equity portfolio for them. Asset management firms such as Black Rock, Fidelity and Capital offer their clients a range of investment funds according to geographical or sector-based spread, investment category and investment strategy. To


\(^{13}\) Swensen, *op cit*, p. 87.
cover an even wider market, they also offer funds of funds, investment funds which invest solely in other investment funds. Morningstar, which makes its business out of comparing the enormous number of investment funds offered, is now making a distinction between 63 categories of investment funds.14

This intermediation of the investment process of institutional investors via external asset managers has consequences for the investment world. Intermediation leads to a concentration of investment decisions in the hands of assets managers, who compete with each other for the institutional investors who outsource their investments.

As a result of this competition, deviations from what is mainstream have become risky: if your investment outcome is bad you immediately lose clients. As John Coffee noted, in the asset management world “it is better to be conventionally wrong than to be unconventionally right”. The competition leads to a pressure on asset managers to continuously show good investment results. If the results are disappointing, they lose client mandates; if results are good, they gain new clients. Short-term results are therefore essential. Institutional investors not only substitute one direct investment for another, but do the same with mandates to asset managers and the investment products offered by them. The competition reinforces the herd behaviour which is directed at diversification whereby following the market and therefore constant liquidity are put first. The ultimate investor becomes more and more removed from individual investment decisions and consequently loses sight of and interest in the individual shares held; and as a result, any sense of responsibility for the success of the individual undertakings in which money is invested.

As manager of investments for clients the asset manager has a fiduciary duty towards his clients.15 All US asset managers are subject to the same prudent investor rule in the UPIA, which compels them to think in terms of portfolio and diversification, i.e. an investment policy that is not focused on an actual understanding of individual companies, but on more or less following the market. This has become standard practice in the investment industry. Robert Monks, the American investment activist recently said at a seminar in London that the asset management industry understands the fiduciary duty of asset managers to mean: “don’t underperform your competitors.” Everything revolves around relative financial performance, keeping up with an index or other chosen benchmark, always measured over relatively short periods.16 Added to this is the fact that the fee structure for asset managers typically is based on the size of the assets under management. As a result, asset managers mainly have an incentive to attract ever more assets under


15 See about the fiduciary duty of pension funds, Maatman’s thesis op cit

management rather than to improve the performance of the assets already under their
management. It is simpler to attract more assets by extra marketing and by paying
distribution fees than to make the efforts that improve the performance of shares in the
portfolio. 17

A public offer on a listed company in which an asset manager invests is an example of
how asset managers perceive their fiduciary duty. The graph below shows the share price
development of a company that becomes subject to a takeover bid. Over time, the share
price has dropped by 25%, from 40 to 30. At that point in time the price has become so low
that a bidder announces a public bid at a price above the original price of 40. In a few
days, the price of the share jumps up to 48. There is speculation of a potential competing
bid, whereas the company’s management believes the bid is too low and does not reflect
the true value of the company.

What does the asset manager need to do? How far does his fiduciary duty go? There is a
chance that the price will increase further because the bid might be raised or a bidding
war may ensue. However, this is by no means certain and there is a chance that the bid
will not go ahead if management continues to oppose the bid and possibly takes anti-
takeover measures. In that case, the share price will probably drop again, possibly even
below 30. A court will probably give the asset manager the necessary scope to act as he
sees fit, provided that in doing so he serves the interests of his client. How asset managers
perceive their fiduciary duty in practice is clear. They sell their shares a few days after the
announcement, cash in on the considerable price increase until then and do not speculate
on any further price increase that comes with the risk of the entire profit disappearing.
They often invoke their fiduciary duty towards clients to cash the share price increase and

17 Davis, Lukomnik, Pitt-Watson, op cit p. 68.
avoid the risk that the profit completely disappears. Competitors pocketing this profit while the asset managers looses the profit by speculating on an even higher price is a dreadful prospect and does not make sound business. This competition analysis does not leave room for an analysis of the long-term prospects of the company compared to the immediate gain available now, or at least that room is not used in practice. Institutional investors who invest directly in the company will probably make a similar assessment. The result is that the takeover is mainly decided by speculators hoping to gain an immediate profit and by a relatively small group of hedge funds which deliberately choose an alternative investment strategy of speculating on a higher (competing) bid. Public attention and scorn is usually directed on these speculators, while the source of the problem is the investment behaviour of institutional investors and their asset managers who live up to their perceived prudential and fiduciary duties.

Other factors
There are more factors determining the investment behaviour of institutional investors. The remuneration of individual portfolio managers within institutional investors and asset managers is an obscure area as we have little or no insight into it. There is a suspicion that the remuneration is often based on achieving investment targets in a relatively short term, from a quarter to a year. A report by Mercer from 2009 indicates that portfolio managers of investment funds often receive financial incentives that are linked to their performance over a quarter against a benchmark or ranking. All to stay ahead of the competitors in the short term.

Prudential solvency rules also play a role beyond the prudent investment rule. The result of the rules for insurers in the European Solvency II Directive, which will come into force in 2012 or 2013, will be that equity investment, compared with debt investment, requires more capital reserves as they are perceived to carry more risk, making debt investment cheaper than equity investments for insurance companies.

A proposed new rule of the International Accounting Standard Board concerning the reporting of pensions will require immediate recognition of value changes in pension liabilities and the assets held by the fund to cover those liabilities, the “mark to market accounting”. The effect of this change will be that pension funds will structure their investments on an even shorter term basis.

18 Simon Wong, op cit, p. 408, citing a senior executive of a UK investment house: “In a takeover context, we would typically sell if the stock price rises above our target price, as this is our fiduciary duty to our clients”.
19 Simon Wong, op cit p. 407.
Finally, I should mention the pressures of the entire investment industry, which earns by advising on and executing investment transactions. This industry does not benefit from profits through value increase of the assets, but only from purchase and sale transactions, from trading. The sector continuously puts pressure on investors to trade and offers new funds and products to lure them into ever more intricate investment strategies that require constant involvement of industry players. Advisory and executing functions are often joined in one investment bank or broker-dealer, which also trades for its own account, so-called proprietary trading. The interests cross over and share the same magic words: trade, liquidity, and movement.

Engagement

So what does all this mean for the meaningful and active role that shareholders and the general meeting should play in the governance of listed companies, according to the modern understanding of good corporate governance? The short and clear answer is: it will not come to much, given the perceptions of institutional investors on what proper investment policy entails and the direction taken by the investment industry. The dominant Modern Portfolio Theory, which prescribes diversification and mathematical comparison with markets and benchmarks, confirmed in the prudent person rule, the intermediation by asset managers and their understanding of their fiduciary duty not to do worse than the competition, the increased distance caused by this between the institutional investors for whose account investments are made and investee companies, added to the remuneration model for portfolio managers, the trends in solvency and accounting regulation, and the persistent pressure from the investment industry to trade shares rather than hold them, all of this makes a meaningful engagement in investee companies an illusion for the mainstream of institutional investors. The knowledge and understanding of and interest in individual companies simply do not exist. I do not mean to imply that there are no institutional investors with sufficient knowledge, understanding and interest that allow for a meaningful engagement or that none of the institutional investors is ever engaged. But the mainstream in the capital markets, the herd of institutional investors, is not. Nonetheless, from a governance perspective we ask for such engagement from institutional investors. The Dutch Corporate Governance Code requires as a matter of best practice that institutional investors assess in a careful and transparent manner whether

22 For a similar view see Simon Wong, op cit. See also the UK Walker Review of governance of financial institutions: “A combination of tax, cost and regulatory factors has over time encouraged the aggregation of investment in institutional hands while, alongside, portfolio theory and investment advisers have driven high levels of portfolio diversification and low conviction investment strategies through fund management mandates. Such outcomes are a rational response to perceived client objectives, commercial incentives and the use of relative benchmarks” (p. 69), see http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/walker_review_information.htm.
they make use of shareholders rights, that they publish their voting rights policy and report annually on the implementation of this policy, and that they report quarterly on the actual exercise of voting rights (provision IV.4.1-3). Section 5: 86 of the Financial Markets Supervision Act goes on to impose an obligation on institutional investors (investment institutions, insurers, and pension funds) which have their seat in the Netherlands and who hold equity investments, to disclose compliance with these provisions in the Code and explain any non-compliance. The result is well known: institutional investors vote but often without much thought. Frequently, they outsource thinking about how to vote to proxy advisors, whose advice is typically followed. The Monitoring Commission Corporate Governance, chaired by Jos Streppel, commissioned a survey in 2010 of the extent to which Dutch institutional investors consult proxy advisors and follow their advice. The following is a quote from the report of the Monitoring Commission:

“Of the Dutch and foreign institutional investors that took part in the survey, 56% indicated that they used proxy advisors. This concerns mainly larger institutional investors. In the category asset managers, 100% indicated that they used a proxy advisor. Smaller pension funds indicated that they did not use proxy advisors. ….. Institutional investors were also asked to what extent other parties influence their vote. Proxy advisors were given the greatest influence. (Other possible parties were interest groupings and other institutional investors). Institutional investors which use a proxy advisor indicate that they only deviate very slightly from the voting advice provided.”

Institutional investors which engage a proxy advisor may at best develop an independent opinion where it concerns investments in their own country, where the investors have at least an own understanding of the relevant circumstances. As to the hundreds or thousands of foreign investments, investors often have no choice but to follow the voting advice of the proxy advisor. The result of this is essentially a form of empty voting. The exercise of the voting right is determined largely by proxy advisors who do not have a shareholding interest themselves.

24 See the report drawn up by Nyenrode University for the Monitoring Commission, concerning shareholder engagement in the Netherlands, November 2010, p. 60-61. Investors indicate that the degree of checking advice from proxy advisors at a scale of 0 to 10 is 8.3 for Dutch companies and 3.4 for foreign companies. The influence of the external proxy advice is assessed by the investors at 5.5 for Dutch companies and 7.8 for foreign companies.
25 Choi, Fisch and Kahan reckon with regard to US companies that International Shareholder Services (ISS), the largest proxy advisor, is able to move 6-10% of the votes cast, taking into account the fact that much of their proxy advice is in line with the preferences that those
Nonetheless, in England the expectations with regard to engagement of institutional investors goes further. The review led by Sir David Walker, into the governance of financial institutions following the financial crisis, concluded that lack of shareholder engagement led to a lack of discipline. The Financial Reporting Council followed the recommendations made in the Walker Review and drew up the UK Stewardship Code, a code designed to stimulate engagement of institutional investors. UK authorised asset managers have to publish a statement about compliance with the Stewardship Code. Foreign institutional investors are encouraged to do the same. The FRC website contains a list of asset managers and asset owners who have published a statement in which they commit to the Stewardship Code.

The Stewardship Code goes further than the best practice provisions for institutional investors in the Dutch Corporate Governance Code. The principles of the Stewardship Code are:

Institutional investors should:

- publicly disclose their policy on how they will discharge their stewardship responsibilities
- have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed
- monitor their investee companies
- establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value
- be willing to act collectively with other investors where appropriate
- have a clear policy on voting and disclosure of voting activity
- report periodically on their stewardship and voting activities.

The question is how realistic all this is in the light of the realities of capital markets and institutional investment. In its guidance to principle 3 (monitoring) the Stewardship Code itself indicates a certain hesitation:

“institutional investors may not wish to be made insiders. They will expect investee companies and their advisers to ensure that information that could affect their ability to deal in the shares of the company concerned is not conveyed to them without their agreement.”

Always being able to trade remains an accepted limitation of the expected engagement. Last autumn I attended several meetings with institutional investors in London where institutional investors have without the proxy advice. The Power of Proxy Advisors: Myth or Reality? University of Pennsylvania Law Review, ILE research paper no 10-24, see http://papers.ssm.com/sol3/papers.cfm?abstract_id=1694535.

they discussed the meaning and application of the Stewardship Code. Engagement and stewardship were interchanged as concepts. I believe it would clarify matters if different levels of engagement are distinguished. I would distinguish three levels: compliance, intervention and stewardship. Thus, engagement is the neutral term, which can vary in intensity.

In the case of compliance there is a limited degree of involvement, merely because the Stewardship Codes and section 5: 86 of the Dutch Financial Markets Supervision Act prescribe it. This is expressed mainly by having a certain voting policy and by actually exercising voting rights, whereby the advice of proxy advisors will be guiding. Compliance-engagement is thoughtless, does not arise from an understanding that engagement adds value to the investment, but only exists because and insofar as it is a requirement.

Intervention goes one step further. Where the situation demands it, the institutional investor enters into a dialogue with the company’s management to make it adjust its strategy or policy. This may be because the company is lagging behind the market and its competitors over a longer period and the investor believes intervention is necessary. But investors have also shown in recent years that they want to intervene when they see opportunities for increasing shareholder value that are not used by the company’s management – often in connection with splitting up and selling off parts of companies (see for example cases in the Netherlands relating to Stork and ASMI). In addition, special issues such as environment and human rights may give rise to intervention. Institutional
investors are increasingly positioning corporate governance in this way - they speak of **ESG:** Environmental, Social and Governance issues and of **ESG investing.** Meanwhile, investment funds are offered which deal with ESG issues as a criterion for investment. This intervention-engagement of institutional investors in an investee company is usually incidental - when the problem has been solved or battled out the attention wanes - and moreover only limited to the specific problem. Much more than compliance, this form of engagement requires actual knowledge and understanding of the company’s specific circumstances and the will to enter into a dialogue, to convince and to persist.

The **stewardship** variant of engagement goes yet further. In that variant the engagement is structural, not limited in time or to a certain problem. The structural engagement is in fact there to add value to the investment in the long term; it is the crux of a different way of investing. Shares are held for longer periods and success is determined on a long-term basis. Not continuously using the exit option that the market offers requires greater involvement of the investor in the company, more understanding, more information, and exercising more influence to protect and increase the value of the investment.

The impression I got in the meetings with institutional investors in London is that the maximum option for most of them is compliance-engagement and sometime intervention-engagement. Always being able to trade, diversification of portfolios and measuring relative performance remain the basic principles. That offers no or hardly any opportunity for a meaningful involvement in what is going on at the companies that they invest in. Compliance is already quite something and intervention is for the connoisseurs. Asset managers indicate that for a small section of the funds offered by them, at best, they will be able to make the occasional intervention. They also mention that they would be able to do more if their clients, the institutional investors whose assets they manage, would be willing to pay for their more extensive efforts. But investors will only do that if they see added value in a greater engagement with companies in which assets are invested. If that added value exists - and many people are sceptical about this - it will only emerge after some time, whereas the corresponding costs have an immediate impact on the results. In the competition with other asset managers and investment products that does not help.

One might think that those who offer index trackers should have more room for meaningful engagement. Apart from purchases and sales that are necessary to copy and follow the index, they do not deal in shares. In that sense they are by definition long-term stable holders of shares that form part of an index for a long period. Nonetheless, the engagement of these investors with the investee companies too is limited, mostly even non-existent. The efforts of index trackers are often exclusively focused on minimalising costs and an optimal tracking error performance (the deviation of the investment result of the tracking fund from that of the index in question). Wong writes that research in
England has shown that of all institutional investors passive index trackers actually pay the least attention to engagement and stewardship.\(^29\)

Compliance-engagement and intervention-engagement are perhaps better than nothing, even though there are some critical comments to make. Compliance-engagement, as included in the Dutch Corporate Governance Code and the UK Stewardship Code, is intended as the minimum level of engagement that may be expected from institutional investors. But in the light of how capital markets and the investment industry operate, the minimum level for many also determines the ceiling: they do not have to do more and therefore will not do more. Intervention-engagement frequently leads to raw activism in practice, whereby an immediate cash-out for investors seems to be the main objective. Whatever these forms of shareholder engagement may contribute, they are far removed from the full role that we expect institutional investors to play in our concepts of good corporate governance.

**Stewardship**

Stewardship in the sense I am suggesting would require something entirely different. It would need a fundamentally different approach by institutional investors to investing. It would require reconsidering the general application of the Modern Portfolio Theory, which has led to far-reaching diversification of securities portfolios, focus on liquidity and constant comparison of the performance with the market. The financial crisis may be a factor in this transformation. It may highlight a new market risk if the mainstream of investors pursues comparable, Modern Portfolio Theory based investment strategies, diversifies portfolios and evaluates their performances in relation to the market. This causes a greater volatility of the market as a whole, to which all investors are exposed. That is all fine as long as the markets are up, but all the more unpleasant if the trend goes down. The *portfolio-insurance* strategy - which requires that shares are sold as soon as prices go down, or that, at least, the exposure to the risk of price falls is covered by derivatives transactions which ultimately lead to more shares being sold - will only result in even faster price falls.\(^30\) Diversification turns out not to be a free lunch after all. Warren Buffett makes interesting observations - under the heading: *Debunking Standard Dogma* - which may strike a chord after the crisis:

> "The strategy we’ve adopted precludes our following standard diversification dogma. Many pundits would therefore say the strategy must be riskier than that employed by more conventional investors. We disagree. We believe that a policy of

\(^{29}\) Simon Wong, op cit, p. 409.

\(^{30}\) See for example Michael Pantzer, Portfolio Insurance – the Same Shortcomings, blog van 10 juli 2007, see [http://www.marketoracle.co.uk/Article1494.html](http://www.marketoracle.co.uk/Article1494.html), see also Warren Buffett, The Essays of Warren Buffett, edited by Lawrence A. Cunningham, 2009, p. 105.
portfolio concentration may well decrease risk if it rises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it. In stating this opinion, we define risk, using dictionary terms, as “the possibility of loss or injury”. Academics, however, like to define investment “risk” differently, avering that it is the relative volatility of a stock or portfolio of stocks – that is, their volatility as compared to that of a large universe of stocks. Employing data bases and statistical skills, these academics compute with precision the “beta” of a stock – its relative volatility in the past – and then build arcane investment and capital-allocation theories around this calculation. In their hunger for a single statistic to measure risk, however, they forget a fundamental principle: It is better to be approximately right than precisely wrong…..

In assessing risk, a beta purist will disdain examining what a company produces, what its competitors are doing, or how much borrowed money the business employs. He may even prefer not to know the company’s name. What he treasures is the price history of its stock. In contrast, we’ll happily forgo knowing the price history and instead will seek whatever information will further our understanding of the company’s business. After we buy a stock, consequently, we would not be disturbed if markets close for a year or two. We don’t need a daily quote on our 100% position in See’s or H.H. Brown to validate our well-being. Why, then, would we need a quote on our 7% interest in Coke?

….If you are a know-something investor, able to understand business economics and to find five to ten sensibly-priced companies that possess important long-term competitive advantages, conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk.”

Are the effects of the financial crisis serious enough for institutional investors to overcome the standard dogma of diversification, market focus and therefore short-term trading and attention? Large asset managers for pension funds such as APG and PGMG have indicated that they want to implement concentration in their share portfolio. In doing so, they notice that they go against the diversification dogma and experience resistance. Regulators for example will tell them they will have to maintain higher capital reserves because of a perceived increased concentration risk. That is the way things go with

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31 Warren Buffett, op cit, p. 98-99. Further on, Buffett cites John Maynard Keynes, to whom the quote: “It is better to be approximately right than to be precisely wrong” has also been attributed. Keynes said: “As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think that one limits one’s risk by spreading too much between enterprises about which one knows little and has no reason for special confidence”, p. 104.
paradigm shifts: they are deemed impossible until they are – often suddenly – generally accepted. Galileo was ordered by the Inquisition to swallow his assertion that the earth revolved around the sun, and mumbled: “E pur si muove”, and yet she moves. Einstein himself did not believe what paradigm shift he had caused by his relativity theories. The consequence in quantum mechanics that a subatomic particle can be in more than one place depending on how you observe produced his famous saying: “God does not play dice”.

Another way of investment also requires a different interpretation of the fiduciary duty of asset managers. Solvency and accounting rules that reward diversification and short-term trading need to be amended. And new expertise needs to be developed by institutional investors, expertise aimed at understanding companies in which they invest, instead of markets and mathematical insights into volatility and market performance. This requires evaluation of long-term economic prospects of those companies, the quality of their management, the markets in which they operate and the value of the business. In that respect, institutional investors can learn from private equity firms, which make targeted investments in specific companies in which they become heavily involved, albeit in a special business model aimed at turn around and exit after a certain period of time. They may also learn from yet another ownership model, from family owners who own companies without any explicit investment horizon.

Will this all come about naturally? I doubt it. We may be in need of catalyst investment funds that take more substantial stakes in a smaller number of companies, for a longer term, based on specific contractual arrangements on information, board participation and exit, and that subsequently manage their investments as stewards, with commitment, with knowledge about the companies in which they invest, and actually engaged in the organisation and decision-making within those companies.

**European Commission Green Paper on Corporate Governance of Listed Companies**

In April 2011 the Commission has launched a Green Paper on the governance of listed companies, following an earlier Green Paper on the governance of financial institutions. A large part of the paper addresses concerns about the lack of engagement of institutional investors and suggests measures that could be taken to improve the level of engagement. The Green Paper is partly based on the advice of the the European Corporate Governance Forum which has, for quite some time now, been considering the problem of the growing disconnect between the trends on the capital markets and in institutional investment, and assumptions of good corporate governance for listed companies. We have indicated to the European Commission a number of areas where company law and regulation of corporate governance could make a difference in a development towards more

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32 Another quote from Keynes: “The difficulty lies not so much in developing new ideas as in escaping from old ones.”
responsible engagement of shareholders with the listed companies that they invest in. These are the following areas:

- acting in concert: existing rules in the Transparency Directive and Takeover Directive may create obstacles to cooperation between institutional investors and should be clarified or revised
- inside information: the tipping ban prevents listed companies from sharing price-sensitive information with some shareholders without informing the entire market; an explicit exception for long-term shareholders should be considered
- proxy advisors: concerns about conflicts of interests in the business model; lack of transparency and competition may require regulation
- proxy solicitation: the introduction of a European “light” system of proxy solicitation may make an active involvement more attractive to institutional investors
- asset management mandates: the contractual arrangements between asset managers and their institutional clients should include explicit provisions about the degree of engagement shown by the asset managers with the companies in which they invest
- shareholders’ committee: the shareholders’ committees could be applied more widely to enable greater cooperation between shareholders and a stronger dialogue with the company’s management.

Most but not all of these suggestions have been included in the Commission's Green Paper. I do not have the illusion that these kinds of ideas will make a decisive difference. They may remove some obstacles for engagement and make it somewhat more attractive and by doing so they may help in challenging and refining the current investment paradigm. A paradigm shift requires stronger stuff, a radical rethinking and redesigning of institutional investment.