Why and How the G-Force matters – Insights from an institutional investor

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1. Introduction and definition

G-Force – or gravitational force is a concept known since Sir Isaac Newton published his main work «Philosophiae Naturalis Principia Mathematica» (Mathematical Principles of Natural Philosophy) in 1687. Gravitational force denotes the «universal force of attraction acting between all matter». It is the force responsible for elements not driving apart and according to the Encyclopaedia Britannica it is «by far the weakest known force in nature». And although it is not widely used to «determine the internal properties of everyday matter» it does, however, «control the trajectories of bodies and the structures and evolution of stars, galaxies and the whole cosmos».[1]

Governance on the other hand was defined by Sir Adrian Cadbury as «the system by which companies are directed and controlled». Thus, a certain analogy can be established and becomes even more obvious when looking further into the different aspects and factors of Corporate Governance. Investors as well as academics have extended Sir Adrian's definition but are always referring to the relationships among the relevant participants and stakeholders within or around corporations. Clearly, mitigating the various Principle-Agent-conflicts through processes and structures are of prime focus for shareholders, boards, and management.

2. The role of investors

Institutional investors have a clear economic interest to demand companies to improve their sustainability performance, incl. their Corporate Governance performance as good governance bears a relevant value potential for companies, investors and stakeholders. Through this value potential, governance has become a must-have and imperative for both, sustainable alpha-generation[2] in active managed funds as well as for passive fund-managers who need to engage further. The ample academic evidence shows that demanding best practice standards and convincing enforcements lead to higher market valuation, lower cost of capital and more stable returns.[3]

1 Encyclopaedia Britannica: https://www.britannica.com/science/gravity-physics
2 «Governance Mechanisms and Equity Prices» – Study by Cremers and Nair (2005); https://ssrn.com/abstract=938528
3 «ESG-study 2018 – ESG-factors and Company Financial Performance» – Study by Bassen, Busch, Friede, and Lewis; https://download.dws.com/download?elib-assetguid=0600ee8f85a54f7da00db5628b4a6628

Further evidence provides for a positive correlation between ESG-factors and operational performance as well as lower cost of capital and financing.[4]

Despite all regulatory requirements – existing and new ones – asset managers, as fiduciaries, are more than ever obliged to integrate Corporate Governance as well as E&S-considerations and data in their investment decision processes to ring-fence their investments and act in the best interest of their clients.

3. Responsible investing and asset allocation

The trend to more responsible investing continues to grow, and the success of the UN supported Principles for Responsible Investing (PRI) is not only determined by the pure number of signatories but also by the assets under management. Per 2021, more than 4,300 signatories to the PRI had more than USD 120 trillion in assets under management. Historically, about 40 per cent of these assets were invested in listed equity, thus, effective stewardship and engagement are an instrument of choice to achieve progress.[5]

As the vast majority of PRI-signatories – about 85 per cent – are asset managers, their role as «classic» long-term oriented institutional investors (incl. pension funds, investment funds, mutual funds, insurances) remains crucial for the functioning of the capital markets. They ensure for sufficient liquidity and long-term stability and serve as fiduciaries, millions of beneficiaries for their retirement or education. Academic evidence confirms that a long-term investment approach delivers superior returns compared to, i.e. hedge funds. High portfolio turnover and associated high costs are also unsuitable as both reduce returns significantly.[6]

By law and guidelines, institutional investors are obliged to vote and act solely in the best interest of the customer. Given that experts expect a further rise in the assets managed by these investors, their role and importance will also continue to grow.

A 2019 study expects institutional investors to manage more than USD 147 trillion by 2025. Global pension funds will increase their AuMs from USD 50 trillion to USD 65 trillion, and ESG assets are expected to account for between 41 per cent to 57 per cent by then.[7]

4. But what are the decisive factors that determine the quality of governance?

4.1 The Role of Boards

First and foremost, Boards are of focus to investors due to the direct influence they, the investors, can exercise on them. Through voting on (re-)election and / or discharge, investors can voice criticism and ultimately decide whether successful directors can continue their service or whether replacements have to be found. Low rates of approval for discharges are typically a strong signal for Boards to engage with investors. The composition of Boards with qualified and sound characters is the key to success for a Board's culture. In order to fully embrace the oversight role of a non-executive director, candidates require a high level of independence, broad knowledge and a long-term oriented attitude. A well-functioning Board also scores high on holistic diversity that considers not only age or gender but also international and professional backgrounds, sector-expertise, leadership and academic-experts. Besides a good mixture of tenures, a continuous succession-planning process helps to ensure that the Board keeps its level of ambition high. Self-assessments and external evaluation should also allow for critical internal discussions. Support from a corporate secretary smooths the day-to-day-business and committees should provide the forum for in-depth discussions so that the Boards' sessions can focus on decision-making and evaluating options. Split responsibilities should also be reflected in the leadership roles, i.e. the Chairperson of the Board, the Chairperson of the Audit Committee and the Senior or Lead Independent Director should interact regularly and allow for effective agenda setting, including views from the Board members.

4 «From the Stockholder to the Stakeholder» – Meta-study by Clark, Feiner, and Viehs (2015); https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281

5 Website PRI: https://www.unpri.org/pri/about-the-pri

6 «Mutual Fund Performance and Costs» – Study by Sharkansky (2019); https://personalfund.com/Mutual%20Fund%20Performance%20and%20Costs%20v2%20FINAL%202019-12-12.pdf

7 PwC-study: Asset and Wealth Management Revolution: The Power to Shape the Future, 2019; https://www.pwc.com/gx/en/industries/financial-services/asset-management/publications/asset-wealth-management-revolution-2020.html

4.2 The «right» Remuneration

The second most influential instrument is the Remuneration system for the executive management. In most jurisdictions with developed capital markets, shareholders are given at least a non-binding say-on-pay on Remuneration systems and / or reports. This is widely used to align the interests of management with those of the shareholders. Remuneration systems are often criticized for being too complex which can be true. Investors have a clear interest of understandable and comprehensive systems that reflect a sound level of ambition, provide for the right balance between fixed and variable, short and long-term elements, account for a meaningful equity link and are transparent. Short- and long-term incentives need to reflect corporate strategic targets – financial and extra-financial. The relevant KPIs and performance-levels should be made transparent so that investors can assess whether these are aligned with their long-term interests. Through share ownership requirements (SOGs) long-term orientation can be demonstrated further.

4.3 Treatment of Shareholder Rights

Another elementary aspect of sound Corporate Governance structures is the treatment of shareholder rights. Any discrimination or unequal treatment of shareholders is evaluated as potential governance risk, i.e. violations violations of one share one vote principle through shares with multiple voting rights, golden shares granting multiple, sometimes disproportionate voting-rights, etc. Due to an increasing number of shareholder resolutions as well as M&A-related and say on pay proposals (refer to 4.2), a fair treatment of shareholders and their rights is obligatory. Also as investors are held accountable for their voting behaviour by their client investors and fund beneficiaries.

Most recently, say-on-climate proposals by both, management and shareholder groups have entered the stage and are discussed during AGMs. The 2021-AGM season has shown that a «golden rule» to evaluate these proposals is still missing and investors face the dilemma that when voting against such proposals – either management or shareholders – could be caused due to missing ambition or because action already taken is considered sufficient. An ongoing debate about the applicable criteria will explore which standards and requirements need to be fulfilled (i.e. certification / approval by e.g. Carbon Disclosure Project (CDP) or the Science Based Targets Initiative (SBTi)).

4.4 Auditors – natural allies for investors!?

As fourth element, auditors play an important role as investors rely on their critical assessment, evaluation and attestation of the information provided by the company. Auditors are ultimately responsible to the Board and are officially appointed by the shareholders. Thus, there is a very distinct connection between them and investors have a legitimate interest in transparency, regular internal and external rotation and structures that prevent conflicts of interest, i.e. in case audit firms are also mandated as consultants.

To allow for enough criticality, investors and regulators have started to implement limits on tenures for both, firms and lead partners, as well as for fees for consulting services.

These four elements are in constant interdependency with each other and can therefore be regarded as the core elements of the Corporate Governance ecosystem.

5. What has gone wrong and why – what has not worked and needs repair or change?

There are three main aspects that can provide answers to this question: disregard of existing regulation, lack of quality in execution and, most importantly, lack of ethical and cultural behaviour. Reasons for disregarding existing regulations can be the reliance on regulatory details, an abundance of figure work or failure of proper risk management and deficient compliance structures. If this is met by lack of quality in executive through disregard of zero-tolerance policy, incompetent or inactive supervisors, and oversight failures of auditors or inactive professional shareholders ignoring their fiduciary duties, companies are very likely to experience severe economic reactions. Although governance also includes formalistic elements, it remains a discipline that relies on character and attitude, understanding of ethical and cultural behaviour and communication. Thus, high ethical standards have to be established and applied and communicated, i.e. the firm's corporate values.

6. Where should we come back to?

Starting with the availability of written regulations (e.g. Codes), such frameworks provide for orientation. Based on these frameworks, companies have to develop their individual commitments and requirements internally and have to show a clear behaviour that goes beyond a formalistic «tick-the-box»-attitude. Corresponding and appropriate internal and external behaviour is fundamental to pursue governance and ethics in a holistic way by responsible managers and supervisors. The ultimate level should be an integrated approach that combines a suitable governance framework with ethical, credible and responsible behaviour to achieve sustainable, excellent Corporate Governance.

7. What is the G-Force and how does it matter?

To conclude, we got back to the beginning: G-Force or gravitational force denotes «The weakest known force in nature that still controls the trajectories of bodies and the structures of the whole cosmos.» Governance – when understood and implemented correctly – should have similar effects in the capital markets.