

Not Your Father's Proxy Season

Featuring:

Tim Youmans, *Head of North America Engagement for EOS at Federated Hermes,*

Ric Marshall, *Executive Director, ESG Research*

Adam Bass (00:03):

This is MSCI Perspectives, your source for global investors and access to research and expertise from across the investment industry. I'm your host Adam Bass, and today is May 13th, 2021. On today's episode, it's proxy season. That's when companies hold their annual meetings, and these include proposals from shareholders about specific actions they'd like the company or the board to take. Right now we're pretty much smack dab in the middle of two of the more anticipated annual meetings. Berkshire Hathaway's was on May 1st, and you may have seen the dustup from that around climate and diversity issues.

Adam Bass (00:45):

The Exxon Mobile meeting on May 26th, well, they will face challenges to overhaul their board and their entire approach to climate change. Now, as our guests would be the first to tell you, when it comes to this type of engagement or stewardship, well, the story hardly starts in 2021. It starts with pioneers like Robert Monks and Alastair Ross Goobey. Now, if those names don't mean anything to you at the moment, they will soon enough. Let me introduce our guests who we were thrilled to get on the phone at the same time. First, we have Tim Youmans head of North America engagement for EOS at Federated Hermes.

Tim Youmans (01:29):

I'm calling here from my home office on the coast of Maine, just South of Portland, and right down the road from me is where Bob Monks, Robert Monks is from, one of the founding people in the whole field of corporate governance, written many books. And one of his proteges is Ric Marshall.

Adam Bass (01:51):

Yes, Ric Marshall, who many of you may know, and who we're very excited to welcome back to the pod. Ric does...

Ric Marshall (01:59):

Corporate governance in general, but I also head up the editorial committee for the ESG part of the business,

Adam Bass (02:08):

The ESG business at MSCI, of course. Hermes has a special significance to Ric because...

Ric Marshall (02:15):

Very early on in my career and way back in 1997, I had an opportunity to travel from Maine with Bob Monks and worked for a period of time at Hermes. And this was very early days in Hermes period of time as an actively engaged investor, as a steward. And a lot of that was thanks to the other person that you mentioned, Adam, Alistair Ross Goobey, who headed up Hermes at that time. And Bob and Alistair met up and made a connection. And we came to London and partnered with Hermes, and created what eventually became the Hermes Focus Fund. And eventually that spun off into Governance for Owners and where Tim is today, Hermes EOS.

Tim Youmans (03:03):

EOS at Federated Hermes is one of the world's largest investment stewardship teams with globally 70 professionals. And we provide engagement and voting recommendation services, combined called "stewardship," on behalf of over 50 pension funded asset manager institutional clients around the world with assets under advice totalling \$1.5 trillion dollars.

Adam Bass (03:32):

I asked Ric what proxy season has been like so far. Here's what he said.

Ric Marshall (03:37):

It's been just a fascinating period of time to be part of that ecosystem. The broader part of the world where big corporations and big investors come together, and interact, and put their

cards on the table in effect because companies must submit their directors to the vote, and shareholder proposals are introduced into the mix, and Hermes is an enormously important player in this space. And right in the middle of what's going on this year in so many different ways,

Adam Bass (04:10):

I followed up by asking Ric why this proxy season is so special. But before we get to that answer, I should tell you that from there on in, honestly, I really didn't have to do much. Ric and Tim had such a strong rapport that the conversation just flowed naturally, and frankly, without interruption from me. So like me, I invite you now to sit back and just listen to two really brilliant guys catch up a bit, explain why this year is so different, and how we got here.

Ric Marshall (04:43):

What's most striking to me this year at a time when we're still very much in the throws of a pandemic of global impact is just how important climate change has become. This is absolutely top of mind for so many investors in so many companies. I guess it's the next big challenge that we face as a global entity, and maybe the pandemic and the global nature of the pandemic has brought that into a sharper relief. That's followed closely by the human capital issues that the pandemic has highlighted, everything from health and safety concerns in the workforce to things like racial diversity, which, I mean, these issues have been around, and argued, and discussed for a long, long time, but I've never seen anything like the level of seriousness that the discourse has taken this year.

Ric Marshall (05:38):

I mean, investors are really, really putting the pressure on companies, and many companies are responding very positively, I might say. Then, of course, there's always a perpetual question about CEO pay, and board skills, tenure, and all of the basics of corporate governance, but they live this year in the shadow of these bigger questions, climate change, biodiversity, racial diversity, human capital issues.

Tim Youmans (06:05):

I would agree with all those, but before we get into the specifics of each one of those, I cannot miss the opportunity, since it is proxy season and CEO pay is always on the ballot, say on pay, at least for North American companies for the most part, to plug my good friend, Ric Marshall's landmark paper, Out of Whack: U.S. CEO Pay and Long-term Investment Returns. The North American team at EOS at Federated Hermes refers to this not on every vote, but on almost every vote.

Ric Marshall (06:39):

That's awfully nice of you, Tim. It's nice to hear, but when I started working on that paper and the immediate predecessor to it, and I went into it and said, really asked a really basic question, "What if we looked at pay from the perspective of 10 years, rather than the typical three years that current long-term incentive plans are organized around?" And the findings were super, super interesting, much of it was really surprising to me, but I think if I did anything important there at all, it was asking that key question, "What if we look at this from a long-term perspective?" And the idea that engagement and stewardship should be focused more and more on long-term issues has risen to greater importance. I mean, it's why we do ESG in the first place, and that really is the context within which much of this is happening.

Tim Youmans (07:36):

So we've pretty much covered the landscape here, Ric. G, executive comp and bodies, a lot of G, not all definitely, but a lot. E, climate, the most important long-term issue for EOS is clients around the world. And the second most important issue is human capital, human rights, racial equity, and inclusion, and related matters.

Ric Marshall (08:02):

I'm really curious to hear from you a little bit more about how your firm prioritizes its selection of firms to focus on. And we saw this just recently with the Berkshire Hathaway meeting where Hermes was one of three major pension funds to file and support a shareholder proposal on climate change. How does all that work? How do you do that work that you do that has become so important?

Tim Youmans (08:32):

It's a pretty simple process that has gone on for a long time in our 15 years of existence as EOS at Federated Hermes. We simply look at our client's holdings, we pull them together, we pick, for the most part, the top 500 or 600 companies globally. And then there is a little bit of a matrixing that goes on with important companies that are important to themes that our clients are caring about, climate. So we'll make sure some of the biggest emitters are in our program. We do try to do a little bit of regional balancing based on our client's holdings. We'll also look at new and up and coming companies that may be huge influencers or disruptors. And a big thing that I hope we'll talk about later is engaging on behalf of companies that have no shareholders at all, but simply have bond holders, the publicly floated debt that we engage on as well.

Ric Marshall (09:33):

And how does ESG fit into the picture here? I've heard you talk about ESG as the embodiment of a series of risks. So when you engage a company, much of your focus is, "Here are the risks that we perceive. You have assets at risk in terms of their exposure to climate." Is that list of at risk elements or factors, is that essentially how you pick the topics and the areas in which you're engaged?

Tim Youmans (10:06):

Both risks and opportunities. We engage with our clients. We formally get together with our clients at EOS twice a year. We have what we call our client advisory council, and our clients are somewhat self-governing. We have a client advisory board. We've been doing this a long time, and we really formalize the feedback that we get from clients. And it's very simple, this is from their composite investment analysis, climate change, number one, human capital, human rights, number two. That's what they think is the most important to their longterm portfolio health. So therefore, it's the most important to us at EOS.

Ric Marshall (10:46):

Do you get pushback on those? When you raise those issues with companies, is that an easy sell these days?

Tim Youmans (10:54):

I would say it's becoming an easier sell. Many companies and regulators, SCC is looking at climate change again starting in 2021, but increasingly companies are indeed stepping up. I would say the big change came when EOS was the author of a shareholder proposal in 2019 at British Petroleum, that through a lot of engagement with the board of BP by EOS, the board of BP supported, I'll say that again, the board of BP supported a climate change reporting shareholder proposal coauthored by EOS. The big thing is that climate change is really not about alpha, it's about beta. Many have talked about this. It's something that affects the entire world.

Tim Youmans (11:48):

So the former idea that you could just externalize these costs really doesn't work, because everybody has to think about this. Let's jump right into Berkshire Hathaway because they're an outlier. Berkshire Hathaway at their annual meeting in response to a climate reporting shareholder proposal that we at EOS co-sponsored along with CDPQ, Caisse de Dépôt et de Placement du Québec, and CalPERS, the California Public Employees' Retirement System, just asking for some climate reporting at the parent company level, because that's the only entity that shareholders can buy shares in [inaudible 00:12:26] subsidiaries.

Tim Youmans (12:27):

Warren Buffett's response was to evaluate our shareholder proposal as, "Asinine." And he said that the company would not do climate related reporting at the parent company level, would not tell its subsidiaries to report up to the company if climate was material to those subsidiaries, and many commentators have evaluated that he's completely out of step. We're seeing a lot of companies now orient reporting of climate change towards TCFD. We're not making enough progress fast enough, and we're not having enough climate reduction action fast enough, but things are moving in the right direction for most, not all, companies

Ric Marshall (13:13):

We've come such a long way from the old knee jerk reaction, "Shareholder proposal? Okay. We oppose it." I mean, this is what companies have done for most of the past couple of decades, but suddenly it's begun to shift. And we are seeing companies start to accept and support. In fact, there are a lot more potential shareholder proposals out there that don't come to a vote because the company management reaches an agreement with the investor who initially proposed the idea, and it doesn't have to come to that point. But when you get to a case like Berkshire Hathaway, it highlights so many different aspects of what's going on here. I know that in terms of the absolute vote, the proposal did not win, but it didn't win because Warren Buffet himself holds 32 about percent of the voting power at Berkshire Hathaway, and clearly, as he stated, voted against it.

Ric Marshall (14:18):

But when we calculated the numbers and looked at the remainder of the vote, it seemed to us, it's a close call, but it seemed to us that the proposal actually gained a slight majority of the independent vote, the non Warren Buffet vote, if you will. And that's incredible, to get that kind of level of support at a company run by Warren Buffet. It's just an astounding thing. It's such a change of events. And again, for me, it highlights the level of seriousness with which investors across the board are looking at these questions.

Tim Youmans (14:57):

Our analysis is showing the same thing. We haven't completed it yet, but indicatively, we do think that the climate reporting shareholder proposal at Berkshire Hathaway in the 2021 annual meeting did get a majority of support from non insider shareholders. So our initial numbers are leaning in that direction as well. I think though even more amazing than that, Ric, is the change that you referred to earlier about major companies now supporting shareholder proposals this proxy season, especially regarding the critically important issue globally, but especially in the US of racial equity. I'll just highlight four companies that received shareholder proposals similar to many other companies that received shareholder proposals about racial equity, equity reporting, racial equity audits.

Tim Youmans (15:57):

It was kicked off by the CEO of IBM, and this IBM board that received a shareholder proposal on racial equity reporting and said, "We don't agree with everything in this, but it's close to what we already do, so we're going to support this." Then he wrote a letter to President Biden and kind of really publicized it, BlackRock, Morgan Stanley, and a bunch of other large financial institutions received a shareholder proposal from Change to Win. And BlackRock also said, "We don't agree with everything in the supporting statement. We don't necessarily know what a racial audit is, but we do a lot of these things already. So we're going to largely support this and implement it," and the proposal was withdrawn. Morgan Stanley said the same thing.

Tim Youmans (16:45):

Wendy's, the restaurant chain company, received a racial shareholder proposal, and the board supported it. So the amount of change that this is representing in US companies is just monumental. Shareholder proposals are by their nature precatory, means they're advisory, they're a wish. And so companies do have some latitude in their implementation of a shareholder proposal, which means that if a company is already doing what the shareholders requests, why don't they just support it?

Ric Marshall (17:18):

I think we're seeing this play out globally. Hermes is a global investor, and so you've got colleagues doing what you do in other regions as well. Are you seeing a similar kind of change in other areas? Is it better? Is it worse? What's the rest of the world look like from an active steward, large investor with global holdings in proxy season 2021?

Tim Youmans (17:46):

Well, the message gets back to the pandemic from a global viewpoint. And that message is that, first of all, it's tragic. There was many deaths, too many, too many deaths around the world, but the economy globally appears to have good prospects to make it through okay on the other side. Why is that? And that is because major central banks, in addition to what governments did, have pumped in excess of \$15 trillion dollars into the global economy since last March. This is probably triple the amount that went into the economy during the global financial crisis.

Tim Youmans (18:32):

Corporations have been both the instruments of the disbursement of this through banks, et cetera, but also have been the recipients of this through central banks participating in the bond markets. Governments have intervened to keep the economy afloat, central banks have.

It appears to have worked. So is there at least a moral obligation to recognize this intervention that have kept all these corporations and therefore shareholders above water? I think boards around the world are recognizing this.

Ric Marshall (19:09):

I totally agree. And I think you introduce a really interesting new player here. It's not just about shareholders anymore, it's also about bond holders, and the importance of their participation in this. But in fact, there's another holder word that comes into play. And we've been hearing more and more of this over the past few years, but I think the pandemic has made this idea even more important, and that's the stakeholder question, which encompasses every player here. It encompasses the world, it's customers, it's employees, it's communities, it's everyone. And it's almost a definitional concept when we're talking about ESG, because it's not just environmental impact and opportunity, it's not just social impact and opportunity, it's about the integration of interests of all of the different players who participate in this broader global economy.

Tim Youmans (20:07):

It is a simple concept that the pandemic has just brought to the front, that if the economy globally, or for any country, doesn't have workers that are employed, and doesn't have healthy communities, and the companies don't have a supply chain, there really is no economy. There is no opportunity. And governments and central banks saw this, and so that's why this unprecedented level of support came out. So beyond the pandemic, it's just important to long-term value creation. And this was recognized, in the pandemic again, by the Securities and Exchange Commission under the previous administration. Chairman Clayton put out a chairman's guidance on April 8th of 2020 that said, "All US companies should put out forward looking strategies that include stakeholder strategy, specifically employee strategies and social welfare strategies, because," in the chair's guidance said, "This is material to investors."

Tim Youmans (21:19):

The forward-looking strategy, and citing all kinds of safe harbors being disclosed, that includes employee strategies is material to investors. Because how do you create long-term value? Well, you have a company. A company has employees, it has customers, it has suppliers, works in communities, it operates on the planet. I mean, all of these things just sensibly go together in the interest of long-term value.

Ric Marshall (21:46):

Absolutely. And thinking about the SEC, and Jay Clayton, and the role of the regulatory bodies within any sovereign economy, it has seemed to me that we owe a debt to the implementation

of say on pay just a few years ago. I mean, prior to that we didn't have the same kind of interaction between shareholders and boards that we see now, at least that's been my experience. It is long seemed to me that say on pay created a doorway, if you will, it opened up a channel of communication between investors and directors, specifically directors, not just management, but specifically the board, that previously did not exist.

Ric Marshall (22:34):

And Proxy season, one of the great revelations of proxy season is how much did CEOs make for last year? And so we're looking at that, and it's getting a lot of press, and there've been some really dramatic votes against pay, but I'd have to say based on discussions with our clients who are looking to us for research, the big issue right now around pay isn't the amount of pay, or that disconnect, or that complexity, those things are being talked about, and there's votes being cast for sure. But the questions we're getting the most often have to do with, "Is the company tying the executives incentives to ESG? If a company has a particularly high profile in terms of carbon intensity, is a reduction in that level being tied to the CEO's incentive package?" That's the number one question we're getting right now. Is that something that you're looking at?

Tim Youmans (23:32):

Yes, but I want to cast this trend in terms of long-term value, and to kind of throw it back to the past. The trend to tie executive comp to some specific ESG measures needs to be where to ESG measures that are material to long-term value. And there's only a few for any company, a few specific ESG categories that are material to long-term value. You mentioned for a big emitter reducing carbon is probably material to long-term value. If you tie customer performance, there's a stakeholder. If you tie employee performance or welfare measures, there's a stakeholder. If you supply, if you have a supply chain critical company, supply chain performance metrics, these are all obvious value creators.

Tim Youmans (24:29):

And there was somebody many years ago that tried to do this, Henry Ford. Henry Ford, not necessarily in his pay, but he tried to give his workers a massive pay raise, because one of the reasons why, because he thought it was a good thing for the economy as the largest employer in the United States at the time. But also he thought that all those employees that got that pay raise would buy a lot of Ford cars, but he got sued by some shareholders, the Dodge Brothers, and that didn't work out too well for him. So this idea of being measured by stakeholders, investing capital allocation, having a capital allocation strategy towards key stakeholders, there's really an old idea, a conservative idea, I think it's not radical, investing in customers, or employees, or the community is just prudent, long-term thinking.

Ric Marshall (25:29):

I totally agree. I think your characterization of that approach as being the more conservative approach is exactly right. With hindsight, after 25 plus years of looking at corporate governance, and looking at CEO pay, and looking at these questions of a relationship between shareholders, investors, and companies, it seems to me that the radical idea was the one that got away with us for a while there. And that was the idea of the premise of shareholder value, because once that took hold, it changed so many aspects of how companies were managed. It's changed how management schools trained executives to lead. It changed how investors and investment research professionals evaluate a company's financials. It changed how we look at companies and their role in society. And it did it in a negative way, in a short-term focused way.

Ric Marshall (26:33):

And to a great extent, my view is that we're seeing the rise of ESG now, not because it's something new, and radical, and, "Isn't that a cool new idea," but in fact it's a reversion to where we should have been all along that we lost track of because we allowed this radical limited vision to take hold and take over. And it lasted too long.

Tim Youmans (27:03):

Now, we do have say on pay in most jurisdictions, but only shareholders have a vote. The bond holders don't necessarily have a vote in say on pay, and I'm not saying that they should, but I think because the 15 trillion was pumped into the economy, and mostly a lot of it was made available directly or indirectly through the bond markets, through different quantitative easing credit vehicles to keep the economy and mostly corporations afloat, I mean, this goes right through the CFO's area of responsibility. And bond holders look at everything. They look at everything in cashflow, because in a loan registrate environment, our bond holder clients tell us that they're interested, not just in return on capital, but return of capital, return of principal.

Tim Youmans (27:58):

And while I'm not saying that bond holders are necessarily engaging on pay, they are engaging on long-term capital allocation. And they are very sensitive to the amount of capital that's put into things like shareholder buybacks versus investing in the growth of the company. How many large cap companies have floated equity in order to stay above water during the pandemic? Hardly any. It's all the lifeline has all been the credit markets, and the suppliers of the credit are looking at these long-term value factors, ESG.

Ric Marshall (28:41):

Makes perfect sense. I've got some data open on my desktop right now. I've got an update of dividend, buy back, CapEx, R&D, and new debt for 2020. I want to append to some previous data that I had, and see what happened last year? How did those relationships play out? And I can tell you from a preliminary chart I've done that buybacks plummeted, CapEx plummeted, and debt skyrocketed. Going to be interesting to unpack that a little bit more and see how does that look by sector? Where was the activity? And so on. But these certainly are interesting times to be a researcher. So we are early days in proxy season, and we've got some big, important meetings yet to come. There was one in particular that I know I'm watching coming up on May 26. I assume you'll be keeping an eye on that one and maybe attending virtually?

Tim Youmans (29:51):

Eos at Federated Hermes I believe will be attending virtually. The Exxon Mobile meeting is what you're talking about, and it's quite interesting, some would say, "Controversial," because an activist, Engine No. 1 it's called, a new activist founded by Charlie Penner, who is the former managing director at JANA Partners. It's an actual proxy contest. They're voting on two different slates of directors, a slate of directors that is offered by the company, the existing company board, but then the activist has a different slate of directors that includes some of the legacy directors before new directors proposed by the activist. And the activist position is that Exxon is not doing a good enough job in climate change, and therefore, is going to propose directors that the activist feels will do a better job governing the company for the upcoming energy transition, and for a low carbon economy.

Tim Youmans (31:02):

So some big investors out there, CalPERS has recently said publicly in an exempt solicitation that they won't be supporting the dissident slate, the Engine No. 1 slate of directors, not the company slate. Legal & General has come out. EOS at Federated Hermes has not come out publicly with our voting recommendation yet. But to say that this vote is getting a lot of interest is a huge understatement, it's going to be very interesting to see what happens. So thanks, Ric. This has been a great discussion, as your and my discussions always are. I have a lot of people to thank, I'll just keep it local though.

Tim Youmans (31:48):

I'd like to thank here in Maine, you. You got in this a lot earlier than I did, and I've learned a lot from you, but I also thank down the road from me, Bob Monks, and all those who founded this whole field of corporate governance many years ago. And I look forward to carrying on this conversation as we traditionally do up in Long Lake of the summer.

Ric Marshall (32:13):

So, Tim, it's been super, super interesting to talk. As you say, always, we have some amazing conversations, both at a high level and also down in the weeds. And a lot of this work really is down in the weeds. It's painstaking, sometimes difficult, complex work, trying to make sense of the world through the lens of corporate stewardship. It's been really, really terrific to visit today. I very much appreciate your time and appreciate Hermes agreeing to allow you to join us on the podcast today.

Adam Bass (32:57):

That's all for this week. Our thanks to Tim and Ric, And of course, to all of you for listening. Before we go, let's check in with what's happening on MSCI's ESG Now podcast.

Mike Disabato (33:10):

Hello everyone. This is Mike Disabato, host of the MSCI podcast ESG Now where we discuss the week's news during an environmental, social, and governance lens. This week, we discuss how company's exposure to modern slavery and coerced labor is affecting both the reputations and the viability of their supply chains. We also delve into the world of mining and indigenous nations, and have a discussion about the hacking of a US pipeline that caused a fuel crisis on the East Coast. Join us this week on Friday and subscribe to our weekly podcast, ESG Now, wherever you get your podcasts from. Thanks.

Adam Bass (33:48):

And don't forget, there's a new episode of Perspectives every two weeks, and you can always find our full catalog on MSCI.com or wherever you listen to podcasts. Until next time, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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