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TRANSCRIPT

Concentrating Ownership

Featuring:

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Bentley Kaplan: Hello, and welcome to the weekly edition of ESG Now, the show that looks at how the environment, our society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode. And for all intents and purposes, this was going to be Mike Disabato's big week back in front of the mic, one of his favorite places to be. But alas, Mike's a bit under the weather. So while you are host with the most recovers, you're stuck with me. And while you're stuck, you might as well kick back and put on the kettle because we're going to draw a big fat circle around the G in ESG. We'll start off by talking to Ric Marshall and Jonathan Ponder about the ownership and control of the world's biggest companies and how quickly recent trends are being accelerated. And then we'll finish off with thoughts from Moeko Porter. Following the assassination of Shinzo Abe, Moeko will take us through his legacy as a key reformer of Japan's governance practices. Thanks for sticking around. Let's do this.

Now, the stars didn't quite align for Mike this week, but that means that I get to talk about one of my favorite topics in the big world of ESG, corporate governance. And our first segment is going to go right to the juicy center of the topic, to the ownership and control of companies. To talk us through this, I was lucky enough to snag the incomparably vulnerable Ric Marshall and plucky young upstart Jonathan Ponder, both from MSCI's team of corporate governance experts. Ric and Jon have spent the past few months waiting through company ownership data. Now after tense conversations and exhausting revisions, their paper was published in early July, titled Ownership and Control 2022: Global Equities Concentration on the Rise. It's freely available on our website. So check it out after the show. Now in the paper, Ric and Jon asked questions about not only key ownership trends in different markets and different industries, but also what that might mean for investors. And for Ric, things got off to a surprising start.

Ric Marshall: First of all, we did a paper in 2015 that looked at ownership and we knew that we needed to update that. So the initial idea was just simply an update focused on our methodology and that very question, why is ownership important? Because ownership in our view is essentially the foundation of everything to do with corporate governance. You have owners who have an economic interest in the company, which then employ professional managers to actually run the company. The owners don't run the company and the interest of the owners are represented by the board of directors.

Ownership is at the heart of that. And how different ownership structures play into and impact the corporate governance makeup of a company, it's a critical part of the assessment and it's an integral part of our scoring methodology.

When we started out, like I say, the initial idea was to update the original paper and that paper was focused primarily on our methodology. Meaning how do we categorize ownership at different companies? Some companies have a controlling shareholder, often it's the founder of the company, particularly with a younger company. Sometimes it's a family. Sometimes it's a sovereign entity, what are called state owned enterprises or SOEs. So we look at all these different forms and we look at the distribution across different markets because different forms have become more important or more dominant in different markets and so on. So that was what we looked at in the 2015 paper. A lot of people have remarked that they found that helpful in understanding how we approach corporate governance. So we collected the data for 2022 and began to look at what an updated version of that paper would look like. And we very quickly realized that we had some changes in the global market that we did not anticipate. And that very quickly became the big story.

Bentley Kaplan: Right. So let's take a beat here. Jon and Ric looked at the different owners of companies in the MSCI ACWI Index, which has around 2,900 constituents. And the easiest way to segment these ownership types is into three buckets. Controlled companies with those where one or more shareholder groups hold 30% of voting shares. Having that much voting power effectively gives a shareholder control over major company decisions. Then you have principle companies. Here, there is still a big shareholder, but they hold between 10% and 30% of voting power, which is enough to be very influential without actually having complete control. And then the third bucket of companies are widely held. Here, there is no shareholder or shareholder group that holds more than 10% of voting rights. So scribble those down on a napkin, three ownership types. Controlled, principal, and widely held.

And as Ric and Jon compared ownership data from this year to 2015, what they saw was pretty striking. Broadly, they found a big jump in the concentration of company ownership. In just seven years, the percentage of controlled companies in the MSCI ACWI Index increased from 32% to 46%, which, take it from me, taking it from the authors, is a big change. And conversely, the number of widely held companies plummeted from 41% to 23%. Now as Ric and Jon told me, as a factor on its own, there's nothing inherently risky or wrong with a controlled company. It's just one kind of ownership type for which there'll be both detractors and proponents. But seeing this rise in the proportion of controlled companies will make many governance analysts sit up and take notice.

Ric Marshall: The big problem with a controlled company is that for other investors, they no longer have influence over the affairs of the company through the traditional mechanism of voting. Shareholders who have come into this company with a minority position, they can vote, but by sheer numbers, they don't have enough of a voting power to actually influence directly the affairs of the company. That's in the hands of the controlling shareholder. You're no longer looking at agency risk. You're no longer looking at the risk of having a professional management run a company for an absentee owner. Controlled companies, in many cases, the controlling shareholder is actually running the company. And so it collapses that principal-agent theory that forms the foundation for much of traditional governance thinking and creates a new kind of risk, which we refer to in the paper as principal risk. So you now have the principals running the company, and it requires a completely different look at corporate governance.

Bentley Kaplan: Okay. Ric is a levelheaded guy, the straightest of shooters, but there is a wry grin in his voice when he talks about the well-known agency risk being replaced by a much newer principal risk. For those outside the rock and roll world of corporate governance. The principal is the beneficial owner, basically the shareholder, who for the most part is not involved in the day to day running of a company. And the agent or agents are those hire to represent the interest of shareholders, basically directors that sit on the board. And a lot of debate has been dedicated to the principal agent problem. This idea that there may be conflicting priorities between a company's board and its shareholders. And this is a really interesting and highly applicable question for widely held companies in particular, those without a controlling shareholder. But as the presence of controlled companies in global markets arises, you end up with principals, controlling shareholders that are often sitting on the company's board.

In a game of I am my own grandpa, these particular principals have also become agents. And for minority shareholders, they no longer only have an agency risk, but also a principal risk. And this shift introduces a somewhat unknown quantity to corporate governance and will no doubt raise provocative questions and challenge long held assumptions about governance practices. And I could quite happily stick a mic in front of Ric and ask him to wax lyrical about this change and governance theory. But for our dear listeners, I wanted to make this more real, to put a little more meat on the bone. And specifically I wanted to get into who is owning these companies.

Now as Ric and Jon tell it, this controlling ownership isn't typically a case of a shareholder picking up shares over time until they wind up with a controlling stake. We're mostly talking about company founders or families that build or even inherit these companies. Or we're talking about state owned enterprises, SOEs, where a government has a controlling stake in a company that has national importance. And these controlling owners are essentially strategic shareholders. And what sets them apart from a typical shareholder is that they have a strategic interest in controlling a company. They're also looking for investment returns. Sure. But control for its own sake is right at the center of this. And each market, and each industry has its own mix of these strategic shareholders. Here's Jon.

Jonathan Ponder: So what I think I found most interesting is actually how dramatically different these ownership regimes can be depending upon the region in question. So, for example, when you look at developed markets, widely held issuers continue to be the strongest and the most prevalent form of ownership. However, when you examine some of the emerging markets, for example, China, there is a dramatically different landscape to work with. Obviously their government has significant oversight over the management and basically the construction of many of their companies, which indicates the... Which is indicated, rather, by the prevalence of SOE and controlled firms within that space. For example, if you move to India for a moment, family controlled companies are quite prevalent as opposed to other entities within that area that rely more upon founder or state control to maintain their major industries.

Similarly, when you examine on a sectorial basis, there are some immense disparities in how ownership is broken down on a global scale. So for example, some critical industries like utilities and energy remain SOE dominant because in most cases, governments require an additional level of control in order to make sure that the lights are staying on, for lack of a better word. Similarly, for consumer staples and real estate families tend to have a higher control block. And this could be perhaps the result of more of a diagnostic approach to managing business and acquiring assets requiring a longer time horizon in order to maintain this profitability and also to accrete size.

Bentley Kaplan: Right. So the flavor of controlling shareholder differs by market and also by industry. And in many cases, these differences are not necessarily new. What is new is how much more common these different types of controlled companies have become. If you're interested in seeing these changes by market and industry, Ric and Jon, with the invaluable handiwork of Ahasan Amin have published an interactive chart in MSCI's insights gallery that will keep you busy for a solid half hour. So do yourself a favor and swing by after this.

So I know we are throwing a lot of terms at you. So let's pick up that napkin again and look back at our original definitions. Remember a controlled company is one in which a shareholder or shareholder group holds more than 30% of voting shares, effectively giving them control of the company. But there's another interesting trend that Ric and Jon were picking apart in a different ownership category. The widely held companies. Remember on your napkin, these are the companies where no shareholder or shareholder group holds more than 10% of voting power. And the trend in these widely held companies was a little different. Not so much about large stakes in a single company, but the size of collective holdings across many different companies.

Jonathan Ponder: Outside of the controlled and principle companies that we examined, we also discovered that there is a new form of concentration currently occurring within the widely held universe. And what I mean by this is there are these large asset managers who in recent years have started to build up larger and larger positions on a global scale across equities that perhaps would not have been a target traditionally. And the mechanism for this is the developing use of index funds. Whereby certain entities have decided to put increasing capital into companies across the world. Now, for our purposes, it became useful to consider some of these entities as universal managers. This is because although these entities are shareholders of the company, they are actually not the beneficial owner, and thus can only be considered an intermediary for the people that are ultimately holding these assets.

Bentley Kaplan: Right. So Jon is talking about some of the world's biggest asset managers that hold stakes in a huge number of companies. In their paper, Ric and Jon provide further details regarding the holdings of these two large investors, BlackRock and Vanguard, which they describe as universal managers. So if we take the MSCI ACWI Index among widely held and principal shareholder companies, BlackRock held 5% or more of 638 different companies. And Vanguard, likewise held 5% or more of 424 companies. This is not about control, but really more about concentrated ownership. You see, over time, these asset managers have increased their stakes in all of these different companies, which Jon and Ric attribute to index based investment strategies. The shorthand Jon used was index funds.

Now how this concentrated ownership plays out in more tangible terms is that these large asset managers were the biggest shareholders at companies like Apple, and Microsoft, and Visa, and Johnson & Johnson, and JP Morgan, and Home Depot, and behind Jeff Bezos, and Elon Musk. They're also the biggest shareholders at companies like Amazon and Tesla. And for me, that raises one really important question because we have this landscape where we see more and more controlled companies. Companies where the voices of minority shareholders are getting softer. So if we're also seeing more concentrated ownership extending to widely held companies, what does that mean for the voting power of minority shareholders in global markets?

Ric Marshall: Both of these large asset managers are very active in terms of stewardship and engaging companies. We can see their influence, I think most vividly in last year's Engine No. 1 campaign at Exxon, where they helped carry the vote that unseated three existing Exxon directors and replace them with more climate friendly, but still very experienced individuals. We're seeing something new happen. Beginning in 2022, BlackRock announced that they would help their clients who wish to vote their own proxies to do so. So that's a new development that suggests a whole different kind of level of commitment to stewardship and engagement, to bring it back to the actual beneficial owners, if you will. So it's unclear how all of this will play out and whether other asset managers will follow suit, but it makes sense that they would do something like that. And it means that more voices will be heard and on a more individuated basis.

Bentley Kaplan: Okay. So Ric has a less dystopian vision than I might have had if I were left in a room by myself for too long, which is good. The more time I spend talking to colleagues like Jon and Ric, the more I learn how much more there is to learn about governance. In a much, much longer interview that Mike recorded, there was so many tempting sidebars about things like control skew, which is the difference between economic exposure and voting power or questions about whether this recent data is going to challenge some conventional assumptions about a company's evolution being from founder owned to one with a principal shareholder, and ultimately to widely held. But for Ric, the data was a reminder that playing devil's advocate can yield surprisingly prescient predictions.

Ric Marshall: You know, a couple of years ago, we published a chart that looked at control skew in recent IPOs, and we put a really kind of provocative title on it. We called it, what if public companies stay privately controlled? We had no idea at the time the shifts that were occurring in the market. But this new paper, I think suggests that in fact more companies are staying not privately controlled, but controlled. So even within the public market, nearly half of the companies in the MSCI ACWI Index are now controlled companies. That's an astounding figure. It's not something we expected, but it was very clear and very important.

Bentley Kaplan: In our next segment, we're also going to reflect on how things have changed for corporate governance, but this time not driven by market forces, but from top down regulation. On the 8th of July, Shinzo Abe, Japan's longer serving prime minister was assassinated in the city of Nara in Western Japan. Although the links between the alleged gunman and the ex-prime minister are both tenuous and intriguing, we are not that kind of podcast. Instead, we're going to pull focus to Abe's legacy. Because aside from being prime minister, Shinzo Abe was a key driving force behind the reform of Japan's governance practices. Way back in the early 2010s, Abe began pushing for changes to corporate governance in Japan as part of a broader economic policy commonly referred to as Abenomics. And Japan's corporate governance code has undergone several revisions since then. To tell us more about these changes in the context of Abe's legacy, I called up Moeko Porter. Yet another governance rockstar, this time coming straight out of MSCI's Tokyo office.

Moeko Porter: So a lot of changes took place under former prime minister's Abe's tenure that have helped shape the state of Japan's corporate governance. First, we had Japan's stewardship code in 2014, and what this did was essentially encourage institutional investors to engage with its investee companies to support sustainable growth. In the following year, we saw the adoption of Japan's corporate governance code, which put the onus on the companies themselves to improve governance practices, to better align with global best practices. I believe the area we've been able to see the most change is actually in regards to board composition.

The governance code, what it did was really emphasize the importance of having outside directors, which at the time was still very much a rarity on these Japanese boards. The corporate governance code has actually been revised twice now. Each time, the scope of the director diversity has been expanded. The 2018 revision it included reference to gender and international experience, and the most recent revision from last year actually added references to work experience and age.

Bentley Kaplan: So there's been a lot of rewriting of Japan's governance codes, which on its own is no small feat. Even only having spent time in the country as a wide-eyed tourist, the intersection between the traditional and the modern is something I encountered time and time again. And taking well-worn practices and overhauling them can naturally create some friction or at least resistance, but as Moeko tells it, these revisions haven't necessarily led to a reluctant compliance approach, but a much more thorough interrogation of governance practices and discussions about what good governance looks like.

Moeko Porter: When we actually look at the boards of these medium and large Japanese companies in our coverage today, we actually no longer see any companies flagged for lacking an independent director. And the number of companies flagged for lacking a female director has dropped from 45% in 2018 down to 7.6%. This obviously trails the 0.5% average across the other developed markets. But there's really no denying that Japan's practices have been improving. And I truly believe having covered the proxy seasons each year for the Japanese market that it'll continue to do so. The discussion has become a lot more substantive. So it's not just about ticking the boxes of getting that female director on the board or that foreign director on the board, but they're also becoming more active discussion about what's an effective board and what that's going to look like for that company.

Bentley Kaplan: And that brings us to our close. In contrast to this idea of corporate governance, being a dry topic with articles of incorporation and company bylaws gathering dust, both our stories highlight how dynamic the topic actually is. For Ric and Jon, their data is almost moving under their feet. Not only showing how ownership is becoming more concentrated, but flipping over traditional ideas of governance risk. And for Moeko, the living, breathing changes to Japan's boardrooms are building on a decade's worth of debate, discussion and policy changes. Not only to see companies doing the mandatory minimum, but genuinely engaging. To quote Ric, the way that governance trends can change is often not something we expected, but it can be very clear and very important.

And that is it for the week. A massive thanks to Jon and Moeko for their take on the news with an ESG twist. And a very, very special shout out to Ric. It's an increasingly rare pleasure to have him on the show, and this episode was no exception. Thank you our most dear listeners for tuning in. Don't forget to rate and review the show on whatever is your platform of choice. And remember that any and all feedback is awesome. It helps us to get better and more importantly, to get you what you really want to hear. Let's keep all our fingers and toes crossed that the fearless Mike will be back with you next week. He has been sorely missed. In the meantime, thanks again for listening and keep on trucking wherever this may find you.

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