

Prepared in collaboration with Oliver Wyman



# Enabling Investor Stewardship in the Global Public Equity Markets

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# Preface



**Shrinal Sheth**  
Knowledge Specialist,  
Shaping the Future of  
Investing, World Economic  
Forum

For decades, the World Economic Forum has championed the notion of implementing stakeholder-oriented business models as a means of creating sustainable value. In recent years, as the concept of stakeholder capitalism has gained endorsements from the Business Roundtable, academics, investors and policy-makers, the call for a redefined economic system that delivers shareholder returns while focusing on sustainable long-term value creation has grown in importance. The work contained in this report was developed over several years, beginning in 2018. Focused on identifying new insights on stewardship in public equity markets, the project included the period of time when the COVID-19 pandemic and the Black Lives Matters movement pushed environmental, social and governance (ESG) issues to the forefront of the global agenda. During this time, addressing ESG challenges became a top priority for many investors and business leaders.

Central to ensuring such systemic change in long-term value creation is the relationship between investors and corporations, two key players in the stakeholder ecosystem. This relationship is complex and deepening. As is the case with almost every industry, the links in the investment value chain are becoming increasingly interdependent and require asset owners, asset managers, affected communities, individuals and corporations to work more closely with one another. Consequently, asset owners are becoming more responsive to their own stakeholders: the pensioners, citizens and social organizations on whose behalf they invest. They are learning to apply their financial, economic and governance insights to address their needs and resolve challenges through the transformative lens of stakeholder capitalism.

This paper explores how investors engage with public corporations to enhance long-term value creation. It examines how varying investment horizons, stakeholder interests, strategies and levels of resourcing can be aligned to form new approaches. For tangible transformation, best-in-class investor stewardship must be increasingly holistic, with a thoughtful approach to 21<sup>st</sup>-century business risks and opportunities. This will require investors to demonstrate an understanding of both company-specific and portfolio-level systemic risks.

Drawing on the depth of the investor and corporate communities of the World Economic Forum, this paper provides a framework to help investors prioritize their stewardship activities based on insights from index managers, active managers, asset owners and activist hedge funds. As investors increasingly view stewardship as an important lever for generating sustainable financial return, it will also help public corporations map the stewardship activities of their investor base to achieve their business objectives.

We thank all of the asset owners, asset managers, corporates, academics, regulators and other experts who have contributed to this work via interviews and participation in World Economic Forum events.

We are especially grateful to Oliver Wyman for their leadership in facilitating the dialogues and for providing their deep expertise in the creation of this report. Their commitment to advancing the aims of this initiative has been extraordinary.

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# The investor-corporate relationship



The investor-corporate relationship provides the foundation upon which all stewardship practices are built. This paper acknowledges certain challenges within the investor-corporate relationship – such as short-termism and shifting governance paradigms – and proposes investor stewardship as a tool to improve this relationship.

The principle focus of this paper is to depict the long-term institutional investor landscape and to describe how and why investors engage in stewardship. It assesses their goals and challenges in conducting stewardship and highlights the financial and non-financial incentives that motivate them to engage in stewardship.

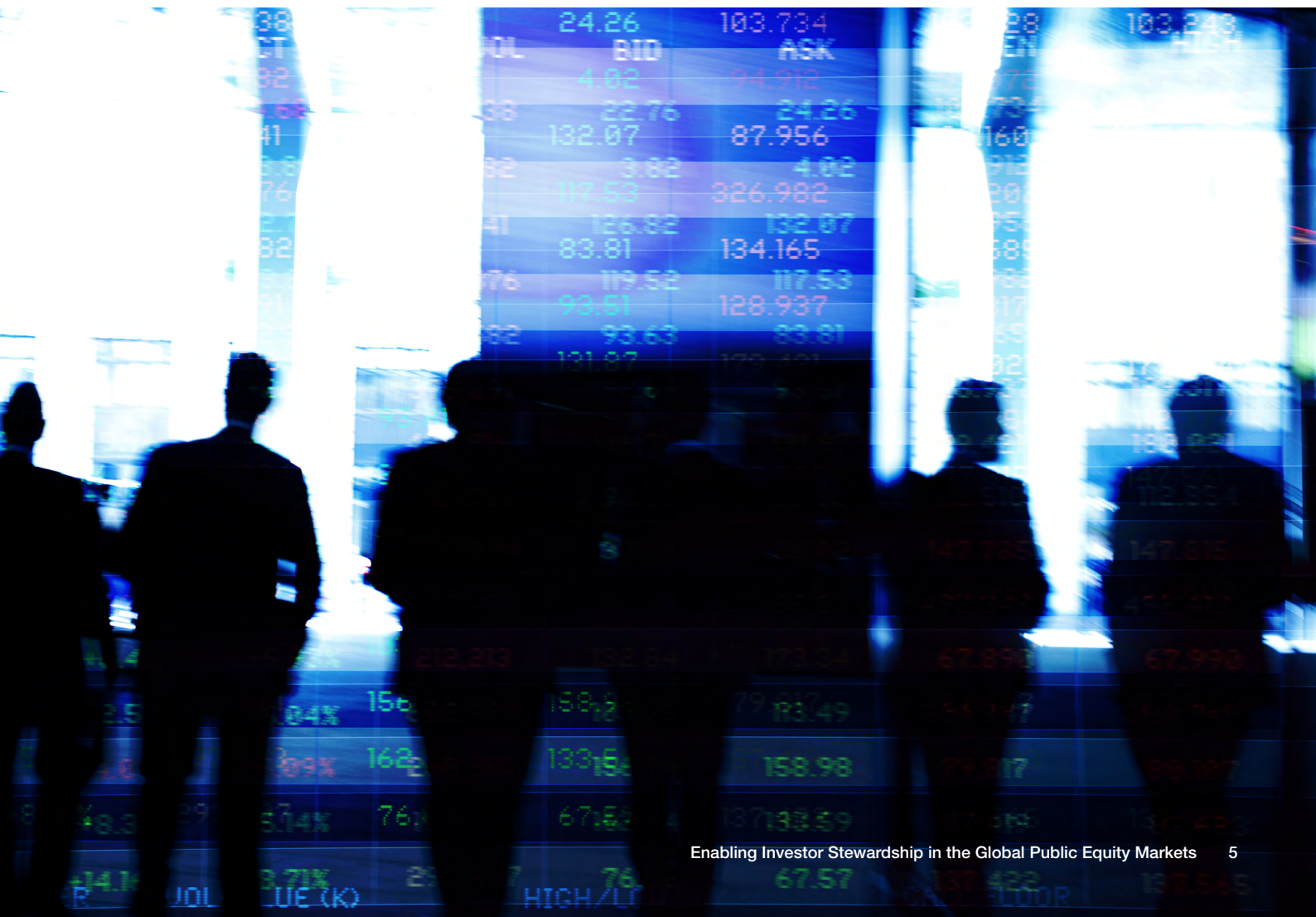
For the purposes of this paper, long-term institutional investors include pension funds, sovereign wealth funds, family offices, insurance companies, endowments, foundations, asset managers, and certain activist investors. This paper also considers the stewardship activities of index investors given their growing scale across global investment markets.

These classes of investors were considered because they have the incentives, capabilities and scale to engage as prudent long-term stewards of portfolio companies. Retail investors and institutions without multi-year investment horizons are not considered to be within the scope of this paper.

## 1.1 What is the investor-corporate relationship?

In the most fundamental sense, this paper views the investor-corporate relationship as a relationship between the provider and recipient of equity capital. Publicly traded corporations issue shares that may be purchased on the open market by investors. Holding these shares entitles the investor to share in the profits of the company and to exercise partial control over it by voting on matters of corporate policy. As the corporation and investment sector have evolved, the flow of information and control between them has become professionalized based

on the view that agreement between investors and management on issues of corporate activity, or principal-agent alignment, maximizes long-term value. In an era of heightened governance oversight and increasing data on corporate financial and non-financial performance, a strong investor-corporate relationship can be harnessed to build upon this traditional role. It does this by incorporating a system of intentional and regular engagement from both the investors and corporates, thus aligning views on how best to maximize long-term return.



## 1.2 Who are the stakeholders in the investor-corporate relationship?

There are two main stakeholders in the investor-corporate relationship within the public equity markets. The two stakeholders below are part of the larger public equity value chain, detailed in section 1.3. The focus of this paper is on capital providers (investors).

FIGURE 1 Stakeholders in the investor-corporate relationship



## 1.3 What are the current issues in the investor-corporate relationship?

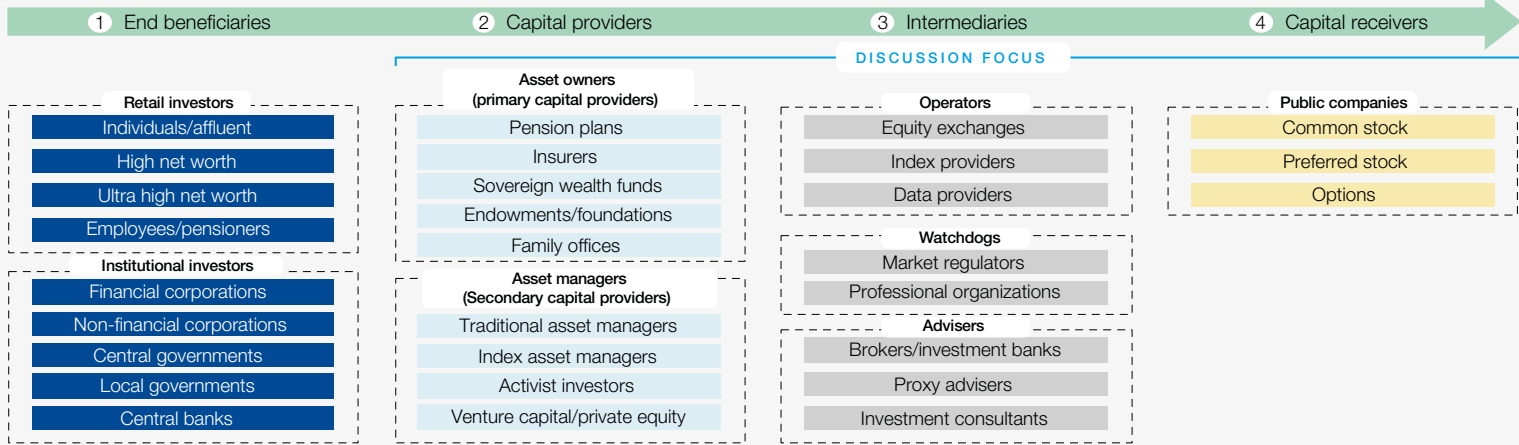
Though both capital providers and capital receivers share the common goal of maximizing long-term financial returns, the two groups often fail to achieve alignment because of issues within the investor-corporate relationship, three of which are listed here.

### Time horizon misalignment within the public equity value chain

Misalignments between capital providers and capital receivers exist due in part to the increasing complexity of the public equity investment value chain and the associated principal-agent problems.<sup>1</sup> As the public equity investment value chain has lengthened, achieving alignment on issues of duration, level and risk associated with financial return has become a more difficult proposition.

FIGURE 2 | Public equity investment value chain

INVESTMENT VALUE CHAIN



Source: World Economic Forum and Oliver Wyman Analysis



Internal misalignment between capital providers (asset owners and managers) results in a more pronounced conflict between the investors and the corporates. Many asset owners invest to achieve returns over a multi-year horizon; however, many of the intermediaries described above face shorter-term incentives. In response, asset owners are making increasingly large allocations to long-term-oriented, illiquid asset classes that have

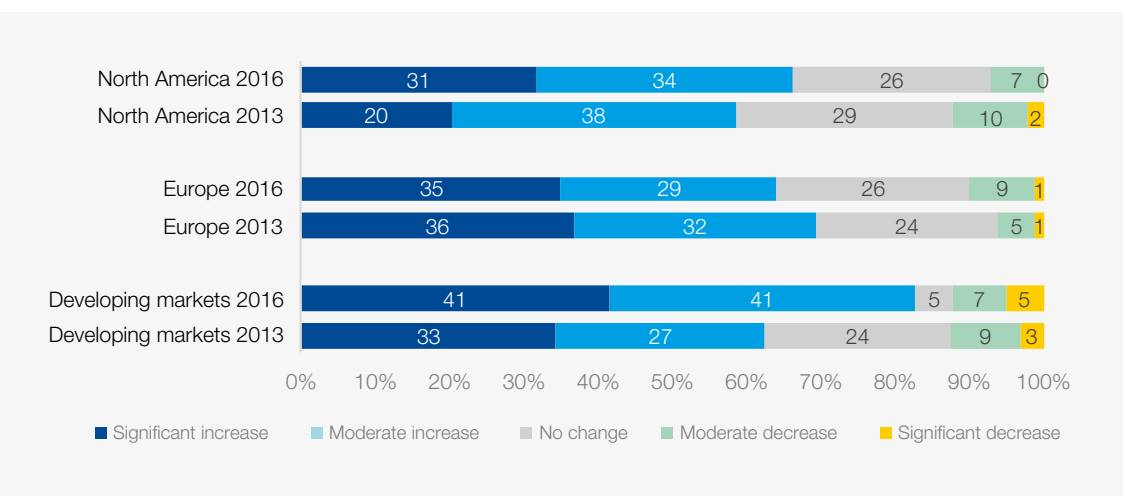
driven returns in recent years,<sup>2</sup> but from a portfolio perspective, this may be exacerbating the challenge of short-termism in public equity markets by placing greater emphasis on their ability to provide liquidity. This may therefore impose short-term pressure on asset managers, whose incentive structures (discussed at the end of this section) and investment mandates from the asset owners reward short-term returns.

## Pressure to sustain short-term growth

This short-termism of capital providers results in increased pressure on management to prioritize actions that result in a good short-term

performance, while neglecting long-term needs such as delaying critical capital expenditure.

FIGURE 3 **Change in pressure on senior executives to demonstrate strong short-term financial performance over the past five years, % of respondents by office location**



Source: FCLT<sup>3</sup>

However, certain capital providers note that this challenge may be partially overcome if corporates can tie short-term performance into long-term strategic guidance and provide details

about the future milestones to ensure that the capital providers are engaged in the long-term performance of the company.

## Stakeholder capitalism

Underlying all of these issues within the investor-corporate relationship is a broader, evolving discourse proposing that business models must incorporate stakeholder interests if they are to prosper over the long term. This discourse and shift in business behaviour, supported prominently in recent years by the Business Roundtable, the World Economic Forum, BlackRock chief executive officer Larry Fink's

annual letter to CEOs, and a community of more than 80 global businesses,<sup>4</sup> effectively expands the playing field of issues considered material to long-term business success. This thematic broadening has created a more holistic set of issues that corporations must address if they are to succeed financially. Consequently, there is a broader set of issues on which investors must engage.



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# Investor stewardship in global public equity markets



Given the potential impact of the investor-corporate relationship on global public equity markets, it is vital that these issues of misalignment between capital providers and capital receivers are resolved. Appropriately conducted, investor stewardship

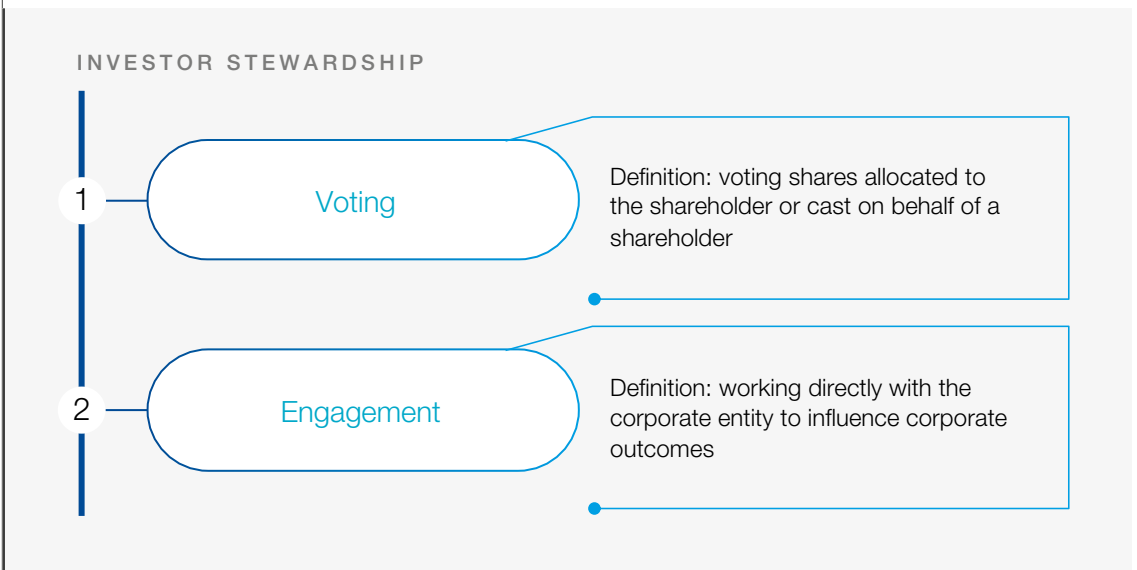
provides a roadmap to engage on these misalignments and move towards better business practices that contribute to a company's ability to deliver sustainable financial returns.

## 2.1 What is investor stewardship?

Investor stewardship can be defined as an investor's "engagement with public companies to promote corporate governance practices that are consistent with encouraging long-term value

creation for shareholders of the company and (*the use of thoughtful*) voting to provide shareholders with the opportunity to express those views".<sup>5</sup>

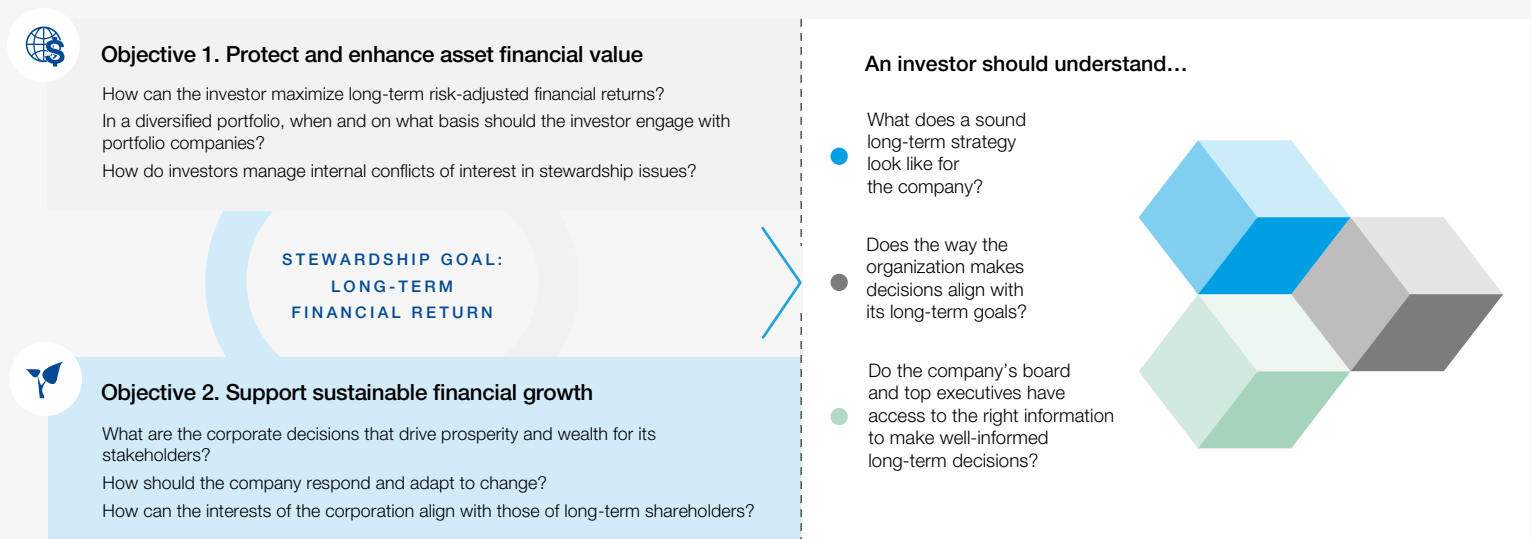
FIGURE 4 Overview of investor stewardship



In this context, investor stewardship implies *active* investor participation as shareholders of their respective portfolio companies. As outlined in Figure 5, the investor's role is not simply to minimize

principal-agent misalignment. Rather, it is to assess and provide feedback on whether the company's policies to ensure appropriate business practices support the investor's long-term objectives.

FIGURE 5 Goal and objectives of investor stewardship



While buy-sell decisions may act as a powerful mechanism for influencing companies, both investors and academics recognize their limits. Thus, investors<sup>6</sup> look to stewardship (and particularly active corporate engagement<sup>7</sup>) as a means of driving better investor returns and stronger governance systems<sup>8</sup> to reduce investor-corporate agency problems.

Many of the world's largest asset owners and asset managers, including the Canada Pension Plan Investment Board (CPPIB) and Blackrock, have publicly stated that they believe investor stewardship is a driver of financial value and a shareholder responsibility. As a result, there has been a shift away from the traditional buy-sell view of the investment industry towards one that values active ownership and the responsibilities that come with it.

## 2.2 Why do global public markets benefit from investor stewardship?

The global economy depends in part on vibrant public equity markets that provide equity capital to corporations in a manner consistent with long-term, sustainable economic growth. Stewardship is a key tool for ensuring alignment across the increasingly

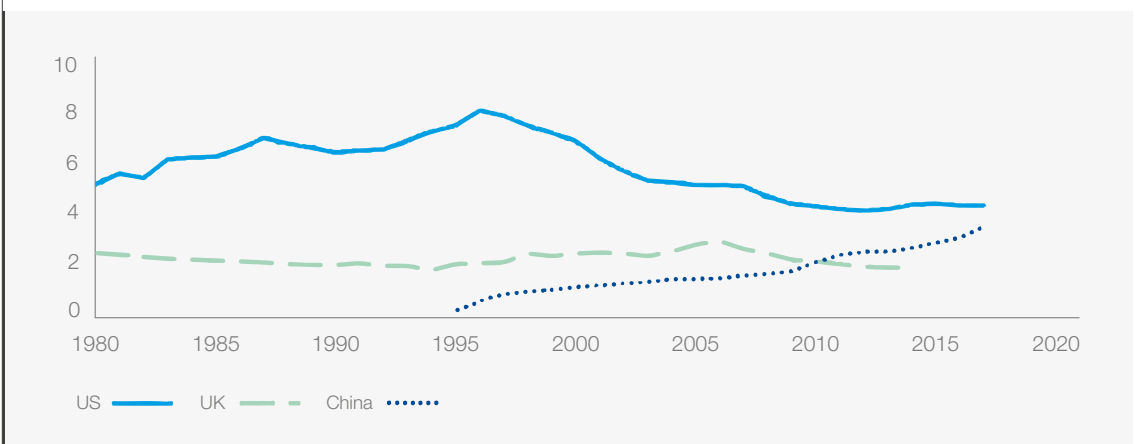
complex investment value chain described above. What follows are insights from a World Economic Forum expert group, which identified some of the most important reasons why public markets benefit from stewardship.

### Ensure health of public markets

While the recent increase in SPACs (special purpose acquisition companies) has somewhat reversed the trend, Bloomberg states that, in the US, “the rate at which new businesses have been offering shares to the public is less than half of the rate prevalent in 1980s and 1990s. US stock exchanges listed ~3,500 firms at the end of 2020, down more than half from 1997.”<sup>9</sup>

Meanwhile, the average stock holding period for the securities traded on the New York Stock Exchange has dropped from eight years in 1960 to just eight and a half months in 2019 and five and a half months in 2020.<sup>10</sup>

FIGURE 6 Number of publicly listed companies in the US, UK and China



Source: World Bank<sup>11</sup>

The declining number of publicly listed companies is due in part to the challenges of balancing investor expectations – in particular, the pressure to ensure short-term financial performance (as described in section 1.3). Private companies, on the other hand, have far less pressure to prioritize short-term concerns over long-term goals. In a 2019 interview with the BBC, Ren Zhengfei, founder and Chief Executive Officer of Huawei Technologies, said, “Why have we succeeded when others failed? Publicly listed companies have to pay attention

to their balance sheets. They can't invest too much, otherwise profits will drop and so will their share prices. At Huawei, we are willing to face the struggles necessary to achieve our ideals. We understand that if we fertilize the soil it becomes more bountiful, and we achieve a better harvest than others.”<sup>12,13</sup>

Ultimately, a lower number of companies going public has the potential to deprive the economy of innovation and retail investors of wealth creation.<sup>14</sup>

Additionally, public markets provide a number of benefits in areas where private capital falls short, including improved wealth creation opportunities for employees and a lower-cost, more stable source of capital for companies.<sup>15</sup> However, investor stewardship provides a tool to bring better

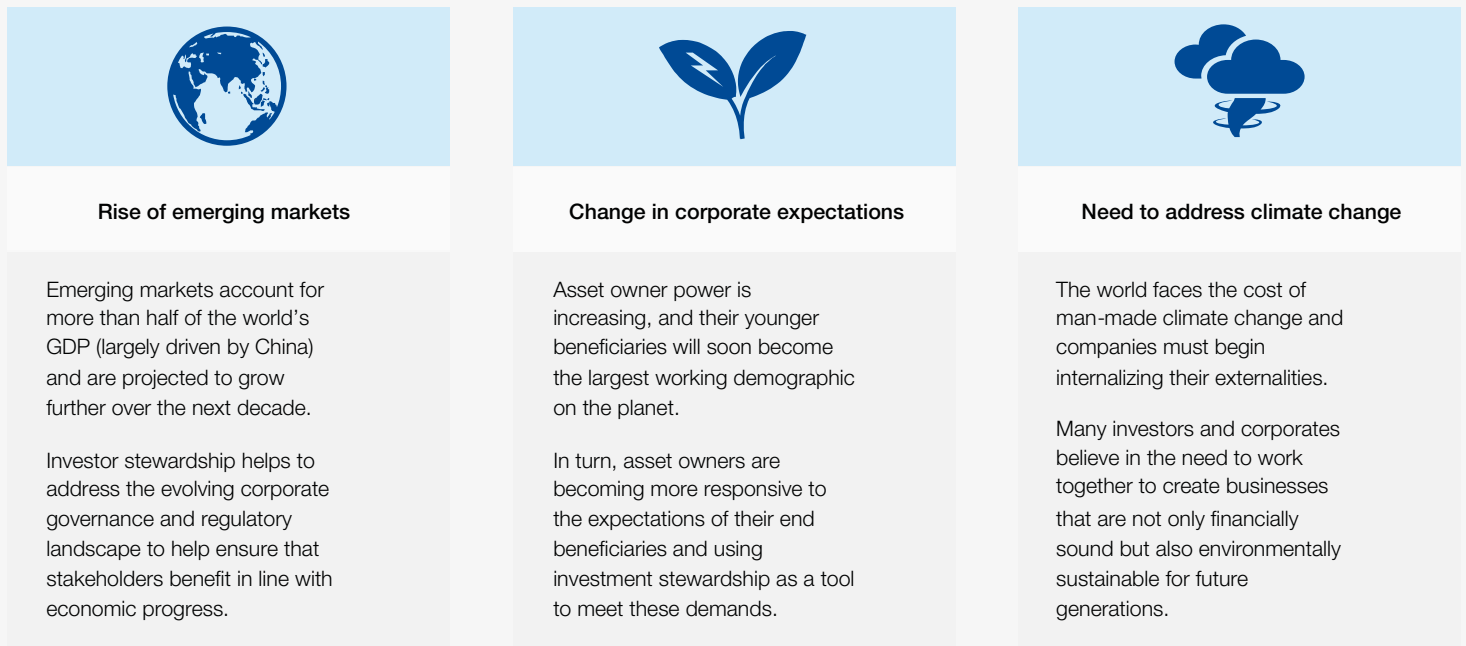
alignment between shareholders and managers. It can be a crucial piece of the larger solution to convince more companies that public markets value long-term focus and that institutional investors in public companies share a long-term vision.

## Shifts in global macro trends

Additionally, the current macro environment reinforces the need for stewardship in public markets in response to three structural changes: the rise of emerging markets, changing governance

expectations and climate change. These trends are reshaping how stakeholders think about company growth and development as well as risk management (Figure 7).

FIGURE 7 Macro pressures for investor stewardship



"There is not just a societal good to be done, but excess return to be captured in identifying and investing in businesses that are emphasizing and addressing environmental and societal problems," said Jeffrey Ubben, founder and Chief Executive Officer of activist fund ValueAct.<sup>16</sup>

Though the economic, governance and climate shifts described above require a response from policy-makers, investors are increasingly viewing these challenges as stewardship issues because of their relevance to generating sustainable financial return.

As Larry Fink wrote in his 2021 letter to CEO's: "The pandemic has presented such an existential crisis – such a stark reminder of our fragility – that it has driven us to confront the global threat of climate change more forcefully and to consider how, like the pandemic, it will alter our lives."<sup>17</sup>

At a micro level, stewardship is a means of aligning investor and management perspectives to improve an individual company's long-term financial return. At a global level, stewardship can positively shape how long-term societal trends drive financial returns.

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# Enabling investor stewardship



Stewardship requires resources and commitment from both investors and corporations. Therefore, both parties must understand and believe in

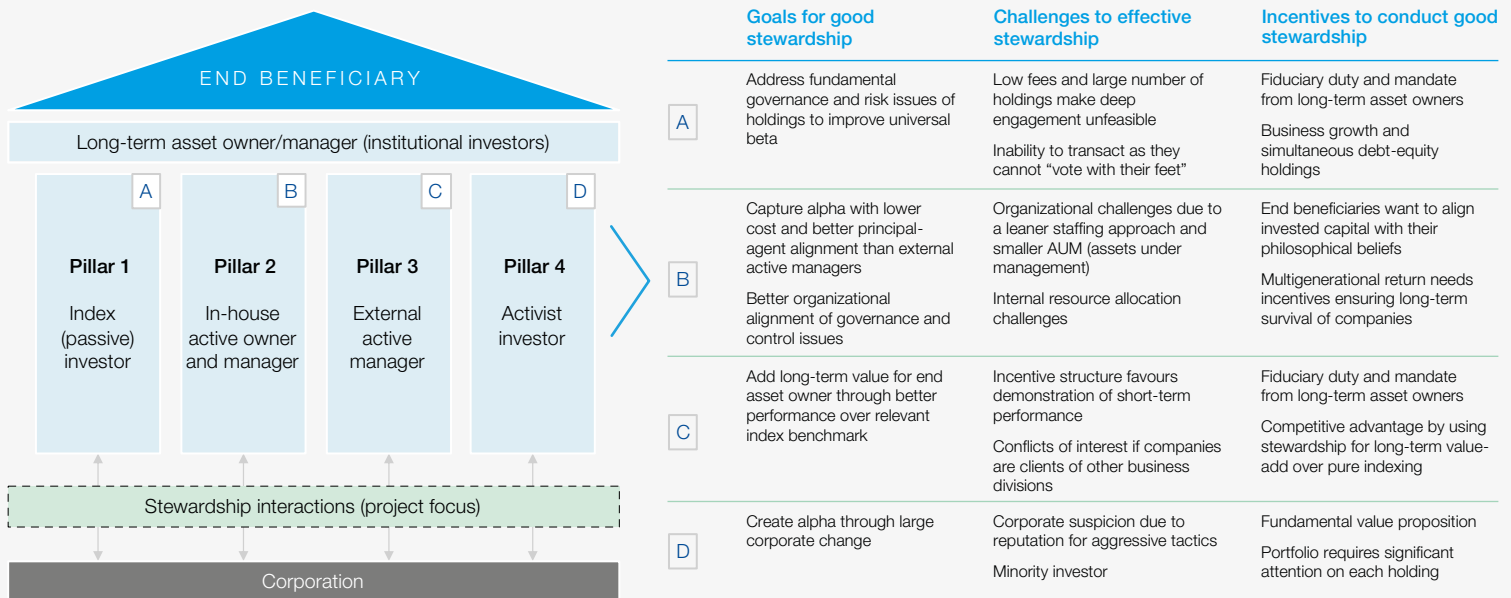
stewardship's often unquantifiable value, as well as the multitude of engagement and stewardship options available.

### 3.1 Why should investors enable good stewardship?

This section reviews the universe of long-term asset owners and asset managers (Figure 8) and consists of four constituent pillars of institutional investors, each with distinct end goals for stewardship. As with any framework, this is a simplified generalization that may not always hold (e.g. activists use a wide array of investment strategies).

This framework serves to identify the unique challenges faced by each of these institutional investors, as well as the incentives that motivate them to actively conduct stewardship activities.

FIGURE 8 Investor goals, challenges and incentives for stewardship



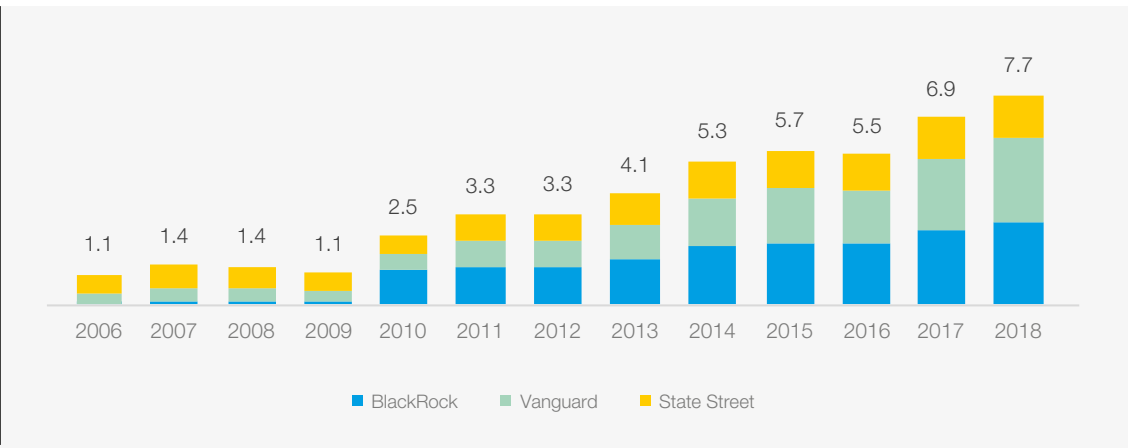
Source: World Economic Forum and Oliver Wyman Analysis

#### Index managers

Assets under management (AUM) by index managers increased significantly in the past two decades as investors fled actively managed funds. At the end of 1998, there were 6.5 times as many assets in actively managed US stock funds as there were in index funds.<sup>18</sup> However, as of April 2019, US passive AUM matches active AUM, moving from \$0.25 trillion in 1998 to almost \$4.5 trillion in 2019.<sup>19</sup>

A 2016 study noted that the "Big Three" index managers (BlackRock, Vanguard and State Street) manage more than 90% of all index funds in the US.<sup>20</sup> The same study found that the Big Three together represented the largest owners in 438 (88%) of the S&P 500 corporations, and in 1,662 (40%) of all publicly listed firms (~3,900) in the US. By the end of 2017, they managed ~\$8 trillion in index equity globally (Figure 9).

FIGURE 9 Total indexed equity managed by the Big Three (\$T), mid-year



Source: Pensions & Investments.

Note: BlackRock acquired Barclays Global Investors in 2009<sup>21</sup>

While these funds have grown in size, there are some challenges that may disincentivize them from conducting stewardship. One reason is that asset managers bear the costs of stewardship activities, but because fees are often fixed as a percentage of AUM, managers capture only a small part of the benefits generated.<sup>22</sup> Most of the benefit flows into the portfolio and hence to the asset owners. Another reason is that there is a belief that the index-manager business model based on low fees, broad-based holding and an inability to make individual buy-and-sell decisions does not allow them to be effective stewards. Academic literature,<sup>23</sup> however, has found that despite their inability to exit investments, index funds have a quantifiable influence on a firm's governance choices via ownership rights and dialogue, resulting in long-term benefits such as more independent directors, the removal of takeover defenses and so on.

Despite these challenges, the behemoth managers understand that there are significant incentives to conducting stewardship. At the systemic level, the Big Three have emerged as de facto standard

setters, nudging corporate behaviour via public letters and by telegraphing voting intentions on evolving risks such as climate change and board gender diversity. Moreover, it has become a vital part of their value propositions, given the increasing client demand for good stewardship. The Big Three have invested heavily in building portfolio stewardship teams and continue to evaluate how much investment can help them become credible stewards of their portfolios. BlackRock, for example, has built the largest stewardship team in the industry, with more than 45 stewardship specialists, and expects to continue to grow the team in the coming years.

"We must be active, engaged agents on behalf of the clients invested with BlackRock, who are the true owners of your company. This responsibility goes beyond casting proxy votes at annual meetings – it means investing the time and resources necessary to foster long-term value," said Larry Fink, co-founder and Chief Executive Officer of BlackRock in his 2018 annual letter to chief executive officers.

## In-house active managers

A study by Northern Trust Asset Servicing shows that 40% of global asset owners increased the number of in-house investment staff in 2015–2018, and nearly a fifth (19%) have upped the proportion of assets they manage internally.<sup>24</sup> This is primarily driven by the need to improve net-of-fee investment returns and governance. An industry study from CEM Benchmarking found that funds with more in-house active management performed better (after costs) than externally managed active investments. This was driven by lower fees.<sup>25</sup> Therefore, asset owners are considering increasing in-house investment management to better align with their long-term investment goals.

Though improved net-of-fee returns is a strong incentive, in-house investment management faces certain organizational challenges. Due to a leaner staffing structure, resourcing the right personnel to manage active strategies and conduct stewardship becomes a daunting task. Often the AUM is smaller than the external active managers and hence the overall transaction costs may be higher. Further, effective risk assessment and analysis can be a challenge in the absence of appropriate internal systems and a team of experts.

Coupled with an improved return profile, these asset owners have two other strong incentives to engage in stewardship activities. First, they have long-term funding obligations that encourage them to ensure the long-term survival of companies in the public markets to safeguard the health of their portfolio. Second, many asset owners manage investments for multigenerational returns and many younger beneficiaries are pressuring them to exercise their rights as shareholders to support corporate behavior that is consistent with their philosophical beliefs.

To address this, pension funds such as the CPPIB are building stewardship-focused in-house management teams. The CPPIB noted that its success in active management relies on having “expert talent, skill and global capabilities, appropriate internal systems, processes and strong operational support”.<sup>26</sup>



## External active managers

“If you look at the hot stocks, US active managers own almost exactly the same as passive index managers,” said the late founder of Vanguard, Jack Bogle.<sup>27</sup> Active investing is notoriously difficult and as index investing gains popularity, long-term asset owners increasingly demand that active managers demonstrate the returns they generate through active management are sufficiently superior to demonstrate the higher fees they charge in comparison to index investing. The Financial Conduct Authority (FCA), a UK financial regulatory body, issued a study in 2017<sup>28</sup> on the UK asset management market which concluded that the majority of active managers underperform their benchmarks after fees.

Given this background, there are certain challenges that the external active managers face in conducting stewardship. First, their incentive structure rewards short-term performance by nature. Therefore, investing in issues such as stewardship with no immediate financial gains is difficult, especially when faced with performance concerns at existing spending levels. Second, active managers often rely on the portfolio manager to conduct stewardship, rather than a centralized stewardship team. While this may offer strong financial alignment in that stewardship and risk-taking are both led by the portfolio manager, it may hinder the application of value-additive stewardship practices across the entire holdings of the asset manager.

However, there are also certain incentives to conducting stewardship. First, external active managers handle substantial long-term capital and some asset owners have investment mandates that require asset managers to conduct stewardship activities. Second, in an environment in which external active managers must prove their value-add exceeds management fees charged, stewardship offers the opportunity to create value through engagement in addition to security selection.

Further, understanding of corporate fundamentals is their prime differentiator as a steward. Through stewardship, asset managers can vote thoughtfully and directly engage with companies to reassess their bottom-up investment thesis, and whether it creates a compelling valuation for asymmetric risk-reward in favor of the asset owner they represent.

As Jean Raby, Chief Executive Officer, Natixis Investment Managers, said, “We believe in an environment where returns will be much less correlated going forward and our strategy of being bottom up and fundamental will pay off. We see an evolving need of our clients towards solutions; this implies the need for a dynamic strategy with various allocations. We bring expertise that (institutional investors) don’t have internally and add a global perspective.”<sup>29</sup>

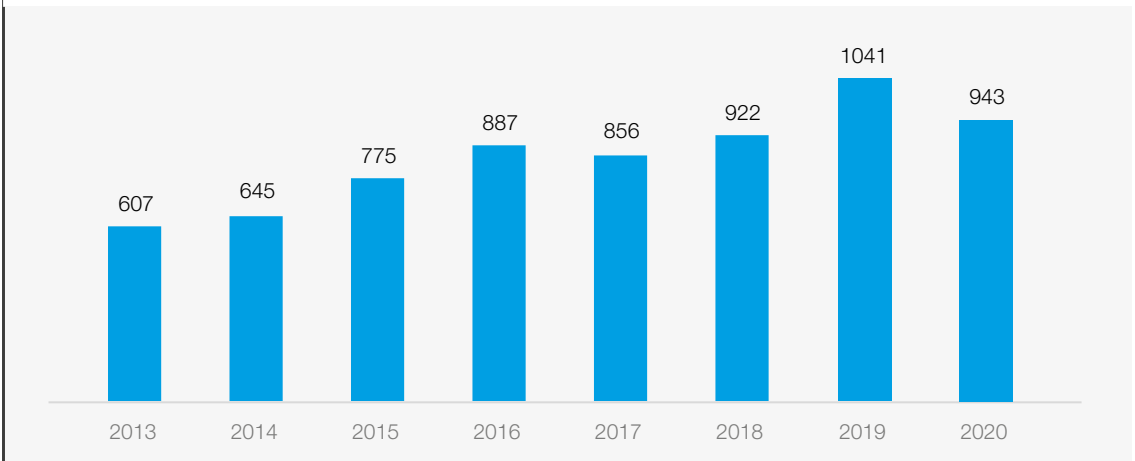


## Activist investors

Activist investors invest in a company with the aim of influencing the company's decision-making process. They do so by purchasing a sizeable equity stake in a public company and using this stake to pressure the management into driving

major strategic or structural changes, often by obtaining seats on the company's board. Over the past decade, their influence has grown, as has the number of companies targeted by activist investors globally (Figure 10).

FIGURE 10 Global activist targets by year



Source: Activist Insight<sup>30</sup>

Despite the growth of their influence, activists face certain challenges in conducting stewardship. Critics of activist investing associate these shareholders with aggressive, adversarial corporate engagement, and believe that they want only quick, short-term returns by moving the share price. However, proponents brand activists as shareholder advocates and believe that they have a clear role to play in reducing management-shareholder agency problems arising due to poor corporate governance and lax board oversight.

Admittedly, not all activists work in a constructive manner. A 2015 study of the topic supports the idea that short-term gains from activists do not come at the expense of long-term performance.<sup>31</sup> A 2018 follow-up study by a separate set of researchers found that, while activists did not help

long-term investors, they also did not hurt the long-term investor.<sup>32</sup> Another challenge they face is that they're minority shareholders and, to move the stewardship needle, they may need support from other institutional shareholders.

However, the activist business model of portfolio concentration and active engagement can greatly encourage them to conduct good stewardship. A thoughtful and collaborative activist can play an important role in driving fundamental changes that deliver long-term value, as demonstrated in the case study below. However, long-term owners should not rely solely on the activists to do their stewardship due diligence, as activists engage only when the value generated is significant and represent only a fraction of the global AuM in equity.<sup>33</sup>

### BOX 1

#### Constructive activism: ValueAct Capital's role in the revival of Microsoft

By 2013, Microsoft (NASDAQ: MSFT) faced years of weak stock performance due to a shrinking PC business. Rivals Google, Apple and Amazon had taken market share from the once-dominant software giant in businesses ranging from search engines to smartphones and cloud computing. Chief executive officer Steve Ballmer had grown net income under his tenure, but the company's institutional asset owners had become increasingly concerned that the company's sluggish internal culture was missing the new computing age.

Against this backdrop, ValueAct Capital acquired a \$2 billion stake in Microsoft in April 2013. Owning just 0.8% of the company, ValueAct's influence

served as the catalyst for change in Microsoft's senior management and corporate culture. Just days after Ballmer's resignation, the activist fund acquired a board seat, which was needed to actively discuss making drastic changes to the company with management – an extraordinary step rarely welcomed by companies.

Jeffrey Ubben, founder and Chief Executive Officer of ValueAct Capital, stated that ValueAct prefers to keep a low profile, work behind the scenes and use public pressure as needed. ValueAct believes in addressing areas in which engagement by traditional long-term investors has failed. It has a long term-oriented model and focuses

**Source:** Discussions with Jeffrey Ubben, Chief Executive Officer, ValueAct Capital, supplemented by articles from *The Financial Times* and Bloomberg

its resources on sitting on boards, working in collaboration with management and allowing them to take credit for positive changes.

While the investment world expected an outside hire as the chief executive officer, ValueAct welcomed insider Satya Nadella to the role in February 2014. He helped to reset the perception and fortunes of the company. Microsoft continued to reform its business model to focus on subscription-based products (e.g. Office 365),

grew its enterprise cloud computing division that had begun under Ballmer (e.g. Azure) and made strategic acquisitions that embraced social networking and open source (e.g. LinkedIn and GitHub).

By the end of 2018, the changes had helped propel Microsoft to the world's most valuable public company by market cap. Its share price traded at \$100, up from the \$30–\$35 range in 2013, when ValueAct first made its acquisition.

## Intermediaries

Finally, ambitions with regards to strengthening investor stewardship have also been growing rapidly among public-market intermediaries. While they are not investors, they provide important services necessary for well-functioning global public equity markets and have the ability to affect the level of value creation through stewardship. Hence,

they are relevant to the discussion about enabling investor stewardship.

The table below summarizes a few important intermediaries and the major benefits they provide and the challenges they present to effective stewardship.

TABLE 1 **Benefits created and challenges posed by important market intermediaries to investor stewardship**

Intermediary	Key benefit created for investor stewardship	Key challenge posed to investor stewardship
<b>Equity exchanges</b>	Set basic governance standards for publicly listed companies	Competitive environment for winning new listings does not incentivize increasing listing requirements (e.g. dual class stock limitations, board diversity, ESG reporting)
<b>Index providers</b>	Provide standardized benchmarks for performance measurement and index creation	Index products create market correlation and fail to reward or punish corporate behaviour
<b>Data providers</b>	Aggregate data to facilitate more efficient analysis	Limit investor access by making data access expensive
<b>Market regulators</b>	Provide oversight to both corporations and investors and ensure that markets follow strong standards	Create regulations counterproductive to investor engagement or sometimes overshoot on policies that create market volatility
<b>Investment bankers</b>	Help to bring companies on to public markets	May fail to advise companies sufficiently well on the level of investor scrutiny public listing will bring to governance, processes, and behaviours
<b>Investment consultants</b>	Help asset owners think about where to invest and focus stewardship activities	Recommend shifts in investment allocation or changes in asset manager

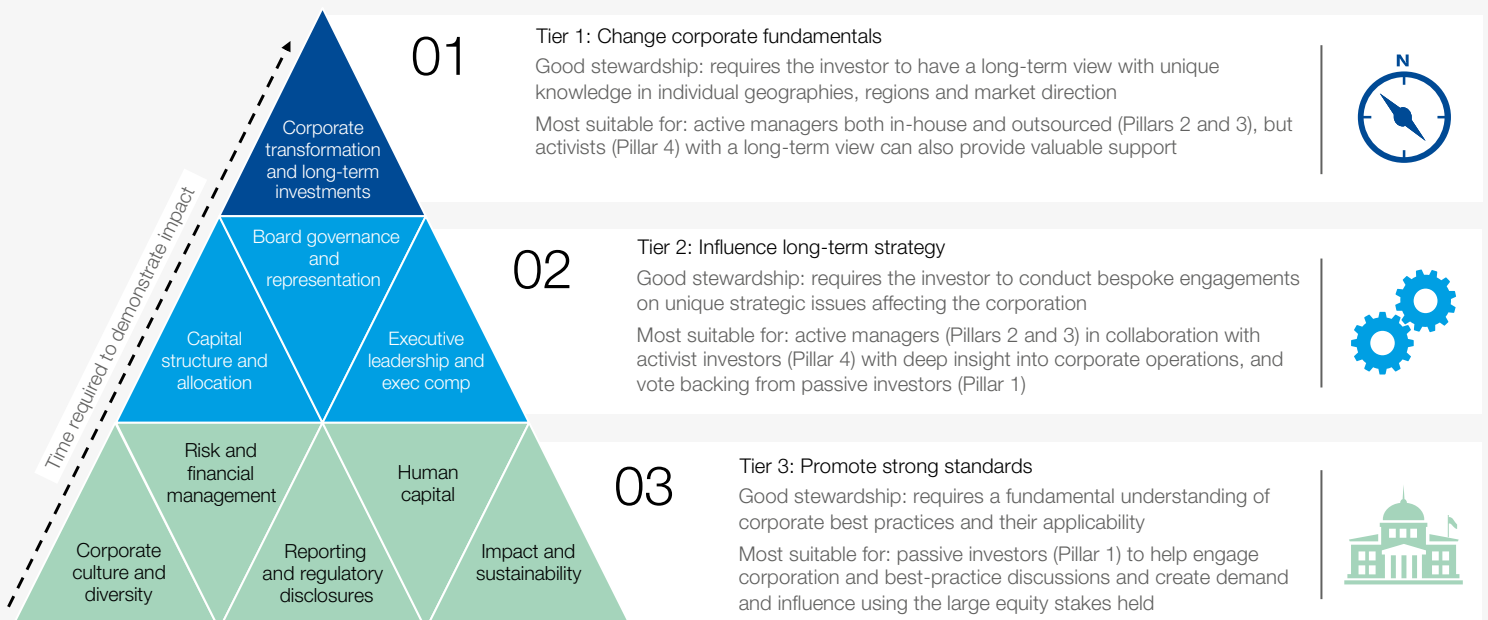
Intermediary	Key benefit created for investor stewardship	Key challenge posed to investor stewardship
<b>Proxy advisers</b>	Provide baseline voting recommendations to investors based on strong standards aligned to those set and used by asset owners and asset managers	Concentrated power in voting recommendation and becoming “quasi-regulators” Arguably understaffed and provide little time for recommendation disputes
<b>Media</b>	Provides information and voice to all players in the stewardship landscape	Focuses on the “loudest” stories, resulting in “media hype,” and may not point to issues that truly affect a company in the long term
<b>Rating agencies</b>	Provide a standardized assessment of a company’s debt-repayment abilities, which helps flag poorly performing companies	May be wary of flagging poorly performing corporations as they pay for the rating assessments

### 3.2 Where can investors enable good stewardship?

The following framework (Figure 11) can help investors think about where they should focus their stewardship activities based on their place in the earlier investor pillar framework (Figure 8). It can also help corporations understand which issues may be front of mind for their investor base.

While this hierarchy is simplified, and in practice investors will engage wherever they feel they may add the most value, it offers a starting point for understanding how different classes of investors may engage in stewardship.

FIGURE 11 Hierarchy of stewardship impact area



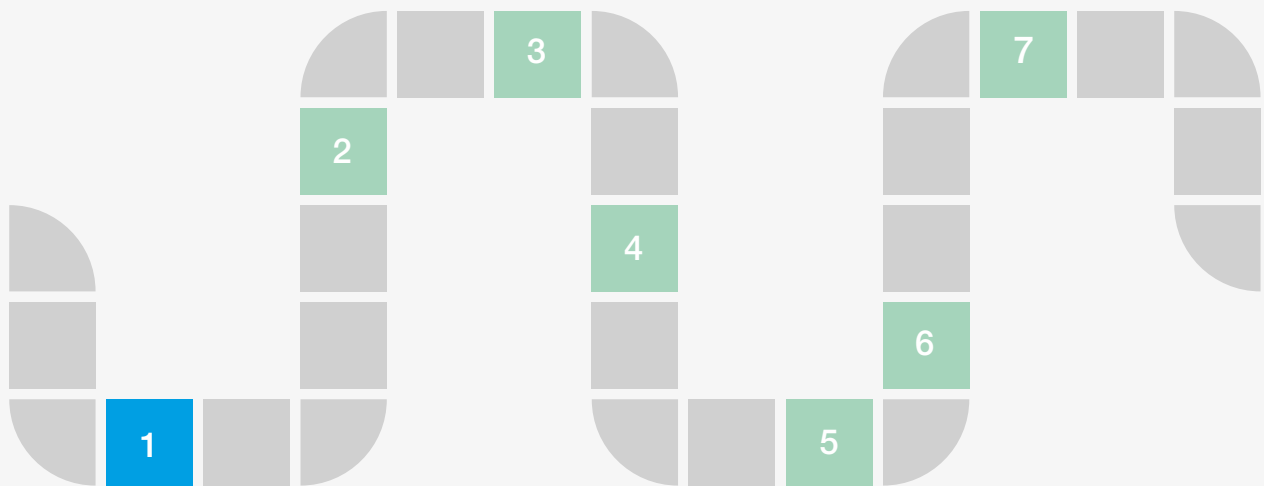
Source: World Economic Forum and Oliver Wyman Analysis

## 3.3 How can investors enable good stewardship?

The options investors use to engage in stewardship are a function of an internal assessment of their goals, challenges and benefits and the agendas they want to drive or react to as explained through the earlier investor pillar framework (Figure 8) and the hierarchy showing stewardship impact areas (Figure 11).

Figure 12 outlines the options available to investors, ranging from those that are less tailored and principle-driven and therefore can be applied broadly across a portfolio, to those that are more bespoke and consequently more expensive

FIGURE 12 Options for investor-directed stewardship



### 1 Coordinated standards (least expensive)

Work alongside other shareholders to make better use of finite stewardship resources through standard setting via principles

*Example:* The Investor Stewardship Group (ISG), a collective of some of the largest US-based and international institutional investors and global asset managers, was formed to bring all types of investors together to establish a framework of basic standards of investment stewardship and corporate governance for US institutional investor and boardroom conduct

### 2 Vote proxies

Vote all shares held and be ready to vote against management if active dialogue does not have a satisfactory outcome

*Example:* BlackRock votes on thousands of proxies, both company-sponsored and shareholder proposals. Due to the more controversial nature of shareholder proposals, BlackRock tends to evaluate shareholder proposals in the context of materiality to the company's long-term performance

### 4 Nominate/replace directors

Review, nominate and vote for board members who share shareholders' long-term interests (e.g. improving experience/knowledge, diversity, gender etc.)

*Example:* Throughout 2017, State Street voted against the re-election of directors at 400 companies on the grounds that they failed to take steps to add women to their boards and failed to make steps to address the issue

### 6 Sit directly on board

Push stewardship agenda by having representatives sit directly on the company's board of directors

*Example:* In 2018, ValueAct Capital took a stake in international electric power producer AES. Jeffrey Ubben, founder and Chief Executive Officer of ValueAct, sits on AES's board of directors, with the goal of helping to push for cleaner energy resources

### 3 Direct management engagement

Discussions with management and board members on issues relevant to the company's long-term sustainability (e.g. wage policies, environmental policies, succession planning etc.)

*Example:* Vanguard conducts engagements with companies in order to drive changes in board, compensation, risk and strategy, and structure

### 5 Discuss/introduce shareholder proposals

Discuss shareholder proposals with long-term financial impact. If necessary, put issues on the shareholder meeting ballot to signal concern or as a catalyst for engagement (e.g. separating chairperson/chief executive officer roles etc.)

*Example:* In 2018, As You Sow, a non-profit foundation chartered to promote corporate social responsibility, filed a shareholder proposal with Starbucks to eliminate plastic straws that subsequently gained more than 30% approval and the company's commitment to phase out all straws by 2020

### 7 Control company capital (most expensive)

Provide liquidity to companies in order to maintain the companies as going concerns, improve cost controls or improve capital efficiency

*Example:* In 2017, Warren Buffett, through Berkshire Hathaway, injected \$400 million equity and provided a \$2 billion line of credit to Home Capital Group that helped stave off a liquidity crisis at the Canadian lender

By harnessing these options, asset owners and managers can raise the industry's standards and their own portfolio values by setting a strong stewardship mandate, customizing engagements for the target company to improve their anticipated returns and providing the means for productive collaboration with their portfolio companies.

Furthermore, this can increase overall shareholder benefits as asset owners who have strong mandates can use the specialized expertise of their asset managers in the context of capital allocation and long-term risk assessment.



# Conclusion and outlook

Investors and corporations must work in tandem to create sustainable long-term businesses that benefit the stakeholder community.

This paper focused on the institutional investor who holds large volumes of public equity. As the topic of stewardship is changing rapidly, our steering and expert committees recommend the following areas of potential exploration to build out the topic:

## 1. What structural solutions can remediate

**short-termism?** Some investors and corporates cited activism as merely the symptom of a short-term-focused market system. Looking beyond traditional agency theory into recommendations of structural solutions to the market (e.g. differential voting rights based on length of time shares have been held, changes in the nature and time frame of investor compensation etc.) could help both the investment industry and regulators think about potential solutions to implement that encourage long-term investing and investor stewardship. Concurrently, the structure of the investment landscape is shifting, as increasingly large and sophisticated asset owners turn to stewardship as a differentiator in a consolidating asset management industry.

## 2. How can retail investors become thoughtful

**voters?** Explorations into mechanisms for increasing retail investor engagement, such as the use of technology to encourage retail investor participation in voting, can aid regulators who want proportional retail shareholder voter representation. Companies, in particular, wish to understand whether technology can improve the efficiency of the overall voting process.

Many academics and industry experts believe that well-informed retail investors who vote their shares add positive value to companies. SEC chairman Jay Clayton noted the importance of this, saying it would be useful to better understand “the extent to which relatively low retail investor participation should be of concern and should inform analysis of existing regulation”.<sup>34</sup>

Research has indeed demonstrated that retail investors vote their shares far less frequently than institutional shareholders.<sup>35</sup> However, the rising discourse of stakeholder capitalism suggests that proxy voting could become an outlet for increasingly vocal stakeholder groups. In recent years, non-profits and other advocates have attempted to harness the influence of retail shareholders. If successful, the mobilization of retail investors as active proxy voters could bring new activity to the stewardship landscape.

## 3. Can investors quantify the value of

**stewardship?** Some experts are looking to quantify the value of stewardship and develop criteria to help differentiate firms on the basis of stewardship. A discussion of the topic would help more investors evaluate identifiable financial value in their own stewardship investments as well as which portfolio companies require focus. Some global initiatives, such as the Task Force on Climate-Related Financial Disclosures (TCFD), have begun to develop intellectual frameworks that tie non-financial issues directly to financial results, making it easier for both investors and corporations to consider how business decisions and engagements translate into financials.

Additionally, the maturation of stewardship as a component of investment organizations, and as an investment function in general, should be further assessed to identify implications on the skill sets and resourcing that will be required.

## 4. Can investor stewardship extend beyond

**equity?** Further study of the influence that debt holders (or simultaneous holders of both debt and equity of a single company) have on that company's strategy would help formulate stewardship best practices outside of the public equity market.

Academics have reviewed simultaneous debt-equity holdings as incentives for more effective investor engagement in areas where investors have a very strong reason to engage, such as bankruptcy.<sup>36</sup> Institutions such as the Financial Reporting Council also promote the idea that non-equity investors can exercise their rights to monitor and engage issuers.<sup>37</sup>

As interest in the topic is on the rise, investor stewardship continues to evolve. Better data, technology and regulation related to the topic will emerge over time. Over the past 10 years there has been a lot of activity in stewardship. Both investors and corporations need to continually reflect on what has worked well, and what needs to change.

The ideal long-term investor-steward will work alongside corporations to meet relevant challenges, not simply as a checkbox exercise but to ensure long-term value creation. Such actions also latently improve the health of public markets and stakeholder outcomes. As stakeholders become more influential, and as managers increasingly understand their importance to business success, the stewardship landscape will continue to broaden. So, while the fundamental mandate of investor stewards centres on good governance and value creation, their actions will beneficially shape the whole economy.

# Glossary

Term	Definition
<b>Active investor</b>	Investors who actively buy and sell securities, with the goal of outperforming an investment benchmark
<b>Activist investor</b>	A shareholder who uses an equity stake in a corporation to put pressure on the company's management to achieve financial or non-financial goals
<b>Asset manager</b>	Profit-driven investment institutions that receive their investment mandates from the asset owners
<b>Asset owner</b>	Institutional investors who own the end capital themselves or on behalf of end beneficiaries
<b>Assets under management</b>	The total market value of financial assets an asset owner or manager manages on behalf of clients and themselves
<b>Beta (<math>\beta</math>)</b>	A measure of a stock's historical volatility relative to that of the market. Index funds attempt to replicate the market return where $\beta=1.0$ , a stock more volatile than the market has $\beta>1.0$ and a stock less volatile than the market has $\beta<1.0$
<b>Board of directors</b>	A group of shareholder-elected individuals tasked with hiring and overseeing the chief executive officer and establishing policies for corporate oversight
<b>Capital provider</b>	Both retail and institutional investors who supply capital to the capital receiver
<b>Capital receiver</b>	The corporation accepting capital from the capital provider
<b>Index investor</b>	An investor with a passive strategy that seeks to replicate the market return
<b>Institutional investor</b>	A non-bank person or organization (e.g. pension funds, endowments and hedge funds) regulated by financial authorities (e.g. the US Security and Exchange Commission) due to its ability to trade securities in sufficient volume or size
<b>Investor engagement</b>	Working directly with the corporate entity to influence corporate outcomes
<b>Principal-agent problem</b>	Issue created when one individual or entity (the "agent") can make decisions or take actions on behalf of another individual or entity (the "principal")
<b>Private equity markets</b>	Consist of equity shares not traded on a public exchange or market
<b>Proxy voting</b>	Voting shares allocated to the shareholder or cast on behalf of a shareholder
<b>Public equity markets</b>	Consist of equity shares traded on a public stock exchange or market
<b>Retail investor</b>	A non-professional investor who buys and sells securities or mutual funds
<b>Stewardship</b>	Thoughtful voting and engagement with public companies to promote practices that are consistent with encouraging long-term value creation
<b>Terminal value</b>	The present value of an all-future cash flow at a future point when modelled future cash flows grow at a perpetual stable rate and, generally, the bulk of an equity security's modelled financial present value

# Contributors

## Project Team

### **Maha Eltobgy**

Head of Future of Investing, Member of the Executive Committee, World Economic Forum

### **Wenhan (John) Lin**

Engagement Manager, Oliver Wyman

### **Samir Misra**

Partner, Wealth & Asset Management, Oliver Wyman

### **Adam Robbins**

Director, Wafra

## Additional content support

### **William Hoffman**

Platform Curator, Shaping the Future of Investing, World Economic Forum

### **Justin Jensen**

Associate, Financial Services, Oliver Wyman

### **Shrinal Sheth**

Knowledge Specialist, Investors Industries, Shaping the Future of Investing, World Economic Forum

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## Steering Committee

**Christian Edelmann**, CFA, Managing Partner, Co-head of Europe, Global Head of Wealth & Asset Management, Oliver Wyman

**Mark Machin**, Former President and Chief Executive Officer, Canada Pension Plan Investment Board

**Ron Mock**, Former President and Chief Executive Officer, Ontario Teacher's Pension Plan

**Barbara Novick**, Co-Founder and Senior Advisor, BlackRock

**Jean Raby**, Chief Executive Officer, Natixis Investment Managers

**Alison Tarditi**, CFA, Chief Investment Officer, Commonwealth Superannuation Corporation

**Jeffrey Ubben**, Founder and Chief Executive Officer, ValueAct Capital

**Jean-Baptiste Wautier**, Managing Partner, BC Partners

**Andrew Weinberg**, Founder and Managing Partner, Brightstar Capital Partners

**Theresa Whitmarsh**, Executive Director, Washington State Investment Board

## Expert and Working Group

### Corporates

**Sarah Elton-Farr**, Head of Global Investor Relations, GlaxoSmithKline

**Raimundo Fernandez-Cuesta Laborde**, Executive Director of Markets & Investor Relations, Acciona

**Peter Hutton**, Head of Investor Relations, Equinor

**Nikolai Lyngø**, Chief Executive Officer, Sval Energi

**Ronald Shaich**, Founder and Former Chief Executive Officer, Panera Bread and Managing Partner and Chief Executive Officer, Act III Holdings

**Natalie Worley**, General Manager, Investor Relations, Rio Tinto

### Investors

**Dominique Barker**, CFA, Head, Sustainability Advisory, Canadian Imperial Bank of Commerce

**Ray Cameron**, Head of Investment Stewardship – The Americas, BlackRock

**Michael Cantara**, CFA, Senior Managing Director, Global Client Group, MFS Investment Management

**Stephen Carlin**, CFA, Global Equities Chief Investment Officer (Interim), Canadian Imperial Bank of Commerce

**Michelle Edkins**, Managing Director, Global Head of Investor Stewardship, BlackRock

**Maggie Fanari**, CA, CFA, Managing Director, Teachers' Innovation Platform & High Conviction Equities, Ontario Teacher's Pension Plan

**Alex Gleser**, Founding Partner and Portfolio Manager, TPG Public Equity Partners, TPG Capital

**Christian Hyldahl**, Former Chief Executive Officer, ATP

**Daniel Jacobs**, Principal, Clayton, Dubilier & Rice

**Christy Jesudasan**, Director, Sales, UK Fiduciary Management, BMO Global Asset Management

**Ben Lambert**, Senior Portfolio Manager, Canada Pension Plan Investment Board

**Justin Nunez**, Partner, TPG Public Equity Partners, TPG Capital

**Mark Oud**, Senior Portfolio Manager, Kempen

**Jonathan Quigley**, Managing Director, Brightstar Capital Partners

#### **Academics/Regulators/Think Tanks**

**Tamara Belinfanti**, Professor of Law, New York Law School

**Kristin Bresnahan**, General Counsel, Alpine Roads, Former Executive Director, Millstein Center for Global Markets and Corporate Ownership, Columbia University

**Stephen Davis**, Associate Director and Senior Fellow at Program on Corporate Governance and Institutional Investors, Harvard Law School, Harvard University

**Andy Griffiths**, Executive Director, The Investor Forum UK

**Mark Manning**, Technical Specialist, Sustainable Finance and Stewardship

**Wei Wang**, Professor, RBC Fellow of Finance, and Founding Director of Renmin – Queen's Master of Finance Program, Smith School of Business, Queen's University

#### **Specialists**

**Gordon Hagart**, Advisor, Ownership Matters and Former Chief Executive Officer, Australian Council of Superannuation Investors

**Scott Kalb**, Chief Executive Officer, KLTI Advisors and Former Chief Information Officer and Deputy Chief Executive Officer, Korea Investment Corporation

**Colin Melvin**, Founder and Managing Director, Arkadiko Partners and Former Global Head of Stewardship, Hermes Investment Management

**Chad Spitler**, Founder and Chief Executive Officer, Third Economy and Former Managing Director, Corporate Governance & Responsible Investment, BlackRock

#### **Workshop Contributing Organizations**

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**World Economic Forum**  
91–93 route de la Capite  
CH-1223 Cologny/Geneva  
Switzerland

Tel.: +41 (0) 22 869 1212  
Fax: +41 (0) 22 786 2744  
[contact@weforum.org](mailto:contact@weforum.org)  
[www.weforum.org](http://www.weforum.org)