



**The landscape of proxy voting at
South African asset managers.**

by Jimmy Winfield
University of Cape Town
July 2011

“Sometimes, a company will get cheap enough to buy as a result of corporate governance issues. However, we believe that we should use our vote for good, not evil.”

If you had the power to improve your situation just by raising a hand, would you nonetheless refuse to exercise this power no matter how bad things are, no matter how much better they could be?

A company’s shareholders have the power to effect meaningful change, thanks to their right to a proxy vote at general meetings. Company law bestows this right with good reason: the issues on which votes are required are integral to the sustainability and performance of an investment. As always, the right to vote comes with a duty to use it wisely. Not doing so would be, at best, wasteful, if not downright irresponsible.

The obligation is amplified for asset managers (AMs), where failure to take voting seriously would also be a dereliction of the fiduciary duty to act in their clients’ best interest. Returns cannot be maximised simply by voting with the feet; by invoking the so-called “Wall Street rule” and selling the shares. Particularly in the concentrated South African market, AMs often hold too large a stake to be able to disinvest without eroding the share price. Besides, a well-informed vote may not only prevent a loss: it has the power to create value by significantly improving the fundamentals of the underlying business.

For these reasons, and in light of recent global events, proxy voting has recently become the subject of much attention as an essential tool for investment professionals to act as good stewards of their (and for AMs, their clients’) assets. Internationally, institutional investors have developed proxy voting policies, and voting records are closely monitored, in an attempt to ensure that the right to vote is used effectively. In order to determine how proxy votes are exercised on behalf of clients in South Africa, a study of most of the country’s larger AMs was conducted earlier this year, including a comprehensive analysis of their proxy voting policies and a series of wide-ranging interviews of senior personnel (see the margins of this report for selected AM’s interview responses).

“We rate each company’s stewardship once the annual report comes out, and compare to last year, in order to form a view as to the company’s value.

Admittedly, of the various components in our analysis, stewardship is the least developed, and is used more for voiding transactions than for identifying opportunities.”

The Good, the Bad and the Ugly

The results are astounding for their variety. In a world where to the untrained eye one investment professional may on the surface appear much like every other, this study revealed some deep differences in procedure, policy, and philosophy when it comes to proxy voting.

Some analysts personally capture votes online; others entrust proxy voting to a paper-based support function; still more outsource proxy voting to an external administrator. AM’s proxy voting policies and guidelines range from less than one A4 page to hundreds of pages. Some interviewees emphasised the importance of adequate attention to proxy voting as “the right thing to do”; others explained that an absence of a decent proxy voting policy is a “deal-breaker” when trying to attract international clients; another began the interview with equally definitive words: “this is bullshit”.

Top Guns

A small handful of AMs stood out as excited, passionate and serious about the opportunity to use proxy voting and other means of stewardship as tools to deliver the best possible service to clients. Typically, these AMs do most or all of the following:

- they have comprehensive proxy voting policies that offer clear guidance while still allowing for flexibility in each voting decision
- they scrupulously inform clients of their policies as well as their voting records
- they generate and acquire detailed research about the issues surrounding upcoming votes
- they are not afraid to engage management on difficult issues like allocation of capital, strategic direction and underperforming directors
- they require and train analysts themselves to prepare recommendations for proxy voting, and portfolio managers to actively oversee these recommendations

Unsurprisingly perhaps, these AMs are characteristically those whose marketing emphasises their responsible investing platform.

There are relatively few such industry leaders in the proxy voting arena, with the majority of AMs falling woefully short of these high standards, as evidenced by both the analysis of policy and the follow-up interviews.

“Generally we show the client the policy, ask for any areas of discomfort, and then the client may instruct us not to implement certain rules. At the end of the day, they’re the clients’ shares.”

Policy Academy

The first half of the study involved an analysis of AMs' proxy voting policies as of December 2010. Independence was assured by redacting all references to AM's names, which were replaced with randomly allocated letters: Manager A, B and so on. The analysis was designed to establish how well each policy serves three vital functions:

1. Providing a workable guideline to internal decision-makers
2. Fully disclosing to clients how the AM enacts its stewardship responsibilities on their behalf
3. Clearly signalling to investee companies what is expected from them

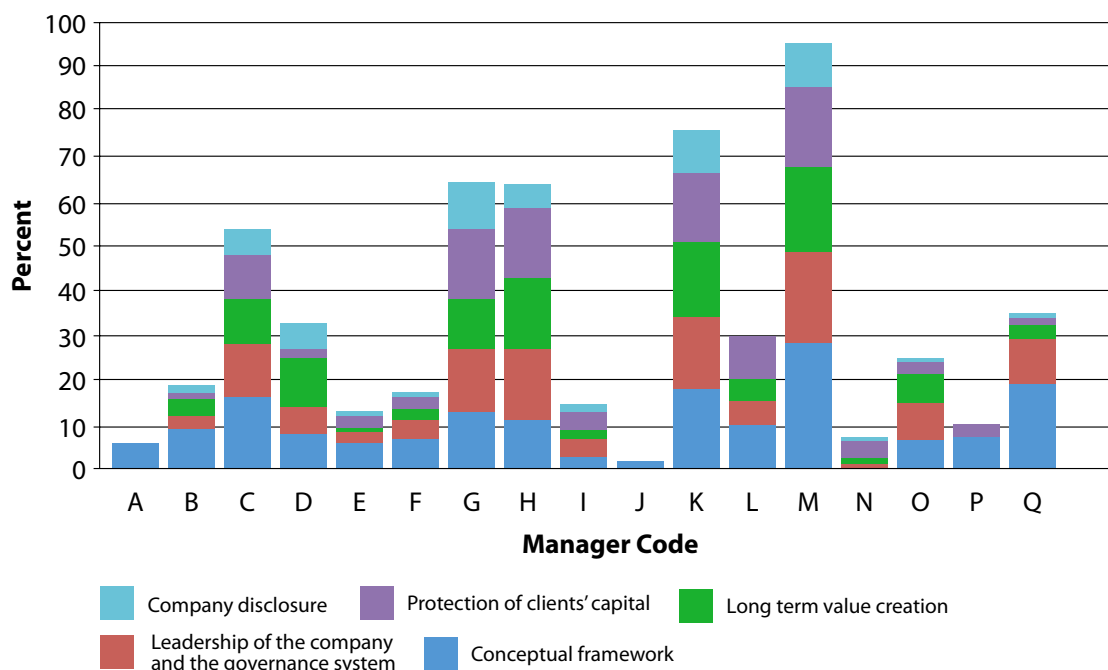
The study assessed the managers' policies with respect to five different factors, with each factor divided into sub-components that were individually scored. The factors (which were weighted according to their importance in order to obtain an overall score) were:

1. Conceptual framework
2. Leadership of the company and the governance system
3. Long-term value creation
4. Protection of clients' capital
5. Company disclosure

The scores for each component were added together to give a total score out of 100. As can be seen in the accompanying chart of proxy voting policy scores, most of the managers achieved an overall score below 30, indicating that on the whole the quality of the policies is fairly low. Even the average score was little more than 30. One of the main reasons for this is that policies are typically presented as a relatively simplistic (and in some cases, copied) set of rules, rather than as the cornerstone of the stewardship function that it should be.

"Our policy is that an analyst decides every vote, and discusses all contentious issues with the CIO. A phone call and email informs management about any no votes in advance."

Results of proxy voting policies assessment



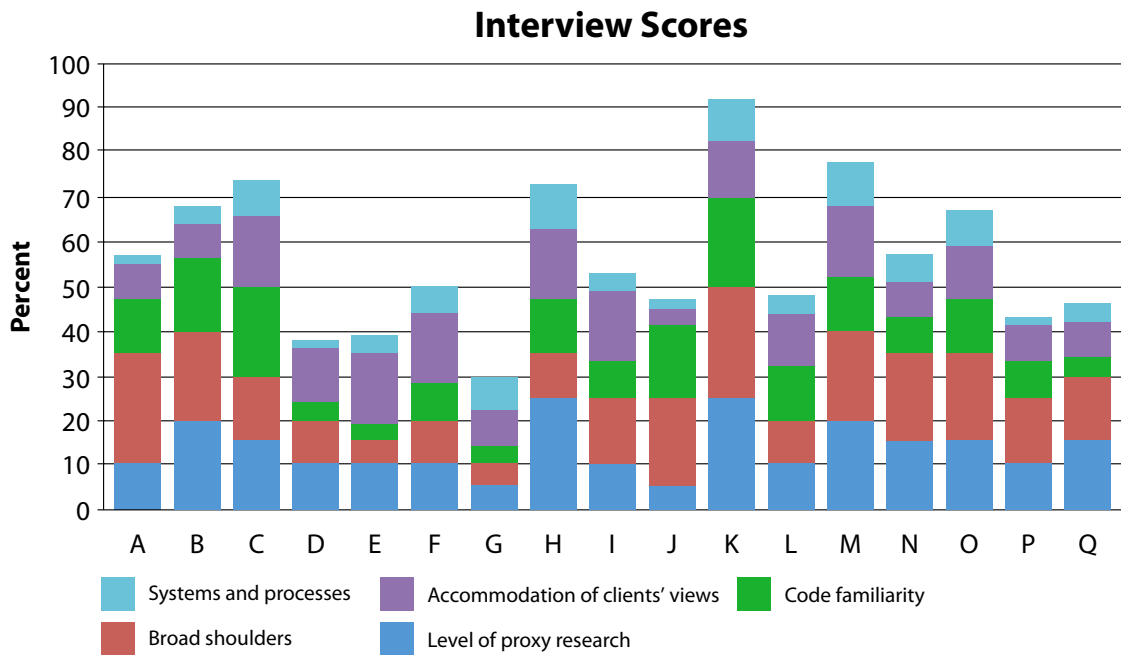
Rocky

“SA is a small investment universe, and so we seldom see a proxy fight. 90% of the time by the time something comes to a vote, the negotiation has already been done upfront. The vote is the weapon of last resort, but in practice it’s usually a rubberstamp.”

Key personnel were interviewed at all of the AMs whose policies were analysed. After these meetings, the interviewers scored AMs in five categories (which were weighted according to their importance in order to obtain an overall score):

1. Level of proxy research
2. “Broad shoulders” (this category evaluated an AM’s tenacity in voting and engaging with investee company management on difficult issues)
3. Code familiarity
4. Accommodation of clients’ views
5. Systems and processes

The accompanying chart of interview scores again shows the wide disparity of AM’s performance in this area. Overall scores varied between 30 and 92, with relatively few high achievers, compared to over 40% who managed less than 50. The average score was 56.



“There is big potential for a headline when a journalist doesn’t understand nuances in our voting decisions, so we prefer to report to clients directly, without disclosing our voting record publicly.”

“We sometimes use the public domain for voicing our opinion about M&A activities that may affect our clients’ investments.”

“Because we are known for being active investors, some investees will take us through the resolutions via conference call a week or so before the AGM, even when we own less than 5% of the shares.”

On the whole, the interviews revealed that AMs are mostly unfamiliar with the documents and institutions that aim to help them develop and implement strong voting and other stewardship policies. The King Code of Governance for South Africa 2009 (known as King III) – widely considered a game-changing touchstone for governance and stewardship – includes a short section headed “Institutional Investors” that stipulates that AMs should “at the very least follow the guidelines laid down by the International Corporate Governance Network (ICGN)”. To assess their familiarity with these guidelines, we asked if the interviewees were aware of the ICGN. Fewer than 30% answered that they were. A sizable minority had not heard of the Code for Responsible Investing by Institutional Investors in South Africa at the time of the interview, a draft of which was released for comment five months before any of the interviews.

Several AMs defended their lack of awareness of such codes by claiming that the documents require an unsubtle and ineffective tick-box approach, but no-one who made these claims appeared to be very familiar with the specifics of the codes.

Many AMs appeared unsophisticated in liaising with clients about proxy voting. While some communicate their voting record to clients on a quarterly basis or even make it publicly available, many do not. Interestingly, though some AMs explain reasons for “no” votes (usually the reason is that it is required by policy), it seems that no-one routinely gives reasons for not voting in accordance with policy, which presumably begs more of an explanation. Furthermore, most AMs are ill-equipped to handle differences between their own policies and those of their clients, insisting that clients concerned about potential differences should exercise their votes themselves.

Most AMs were unclear about procedural aspects of proxy voting. For example, when scrip is lent out for the purposes of a short sale, the voting rights pass to the borrower of the scrip (lenders no longer own the share – instead they now own a right to receive a share – and therefore do not have the attached

voting rights). Loaning scrip may significantly impact an investor's voting power, and so AMs should consider recalling loaned scrip before an important vote. Disconcertingly, only a tiny fraction of interviewees even knew that voting rights are sacrificed when scrip is loaned out.

Another area of confusion is the issue of canvassing other investors about their intended votes. Some AMs believe that there is nothing wrong with asking other AMs who hold the same share how they plan to vote on a contentious issue; others are so wary of "acting in concert" that they refuse to respond to such enquiries. It seems reasonable and ethical for co-owners to voice and discuss their opinions about the quality of their investments with each other, but AMs appear to have received confusing and widely differing legal advice as to whether they would be breaking the law by doing so.

Rules of Engagement

Perhaps to gain a competitive edge in the relatively small South African investment pool, most AMs interviewed engage vigorously with investee company executives. Arguably, a closer relationship leads to better information and a stronger valuation, but it also gives an opportunity to change the strategic direction of investee companies.

Several interviewees, especially at the larger AMs, were at pains to emphasise the relevance of engagement with investee companies, explaining that sometimes their clients never come to know about some very fierce battles fought privately on their behalf. In essence, having the right to a substantial portion of votes can confer enough power that an AM can significantly influence an investee company without a vote ever taking place (e.g. by obtaining the resignation of an underperforming director or by forcing management to abandon or modify a proposed issue of shares). In fact, when an AM holds 5% or more of the shares of the investee company, management will generally contact the AM about upcoming, potentially contentious votes, and the issues are hashed out in private, averting a dramatic debate at the AGM.

Where insider trading may be an issue (e.g. where AMs are offered non-public information about a company's plans to raise capital for a specific purpose), AMs either choose to remain uninformed, or they "come across the line" by resolving to stop trading the company's shares until a date by which management commits to making the information public.

Although AMs generally gave impressive accounts of energetic and, at times, courageous bouts with management, the study also found that there is generally a disconnect between those responsible for proxy voting and those responsible for engagement with company management. Often, the person leading the engagement is in fact oblivious of how votes were cast or even of the percentage of the company owned.

"Sometimes we invest in a company whose ESG issues we don't like, but then we spend time engaging with the executives, do a presentation to the Board, and get our big clients involved, if possible."

"If an organisation disregards its broader community, then it will undermine long-term owner interest. If a business abuses its workers or a family-owned company generally disregards minorities, same thing. In these cases the rating our analysts apply to the projected cash flow stream would be lowered for valuation purposes. We would also consider engaging with management if we own the share."

Resolutions on which proxy voting policies commonly recommend a "no" vote

1. Appointment of directors: appointments en bloc; appointments not in accordance with King III; appointments of "independents" that are not truly independent; poor attendees; members of investment team
2. Directors' remuneration: "unreasonable" compensation arrangements, including unjustifiably large severance pay, golden parachutes, or repricing of options
3. Dual capitalisation: resolutions that create unequal voting or dividend rights, especially where the motivation is to concentrate insiders' power
4. Authority to place unissued shares under control of management: many policies recommend a "no" vote if more than 5% of issued shares
5. General authority to issue shares for cash: many policies recommend a "no" vote if more than 5% of issued shares
6. BEE transactions: deals which are not broad-based; deals with an "unreasonably high" dilutive effect (limit sometimes set at 5% or 10%)

Note that this is not a complete list; it is intended only as an example. Also note that most AMs' policies retain the flexibility to depart from these guidelines on a case-by-case basis.

Internal Affairs

Many interviewees confessed to cultivating a professional skepticism about the abilities and motivations of the management of investee companies, at least until management have proved themselves competent. Unsurprisingly, AMs feel more comfortable when key executives have “skin in the game”, as their motivation to act in the interests of owners is assured. AMs’ insistence on evidence before putting their faith in management is no doubt healthy, given their responsibility to ensure that client’s funds are not exposed to unnecessary risk.

This does present some challenges for AMs who are part of larger financial services groups, where other segments of their groups may be earning fees from the same investee companies by for example advising on a transaction. A few interviewees, in fact, recounted receiving thinly veiled threats from investee CEOs, implying that unless the AM voted in accordance with management’s recommendations, another segment of the AM’s group would lose the investee company’s business.

All AMs who were part of larger groups were quizzed about the potential for such conflicts, and most were quick to provide reassuring accounts of Chinese walls, independent management structures, and in several cases, unequivocal communications from the centre to ignore the possible perils for other business units of unfavourable voting and company engagement. Such responses were used to determine these AMs’ scores in the “broad shoulders” category (see the chart of interview scores).

Back to the Future

“We don’t like to grandstand in the media, but there are many examples of how we make a difference behind the scenes...”

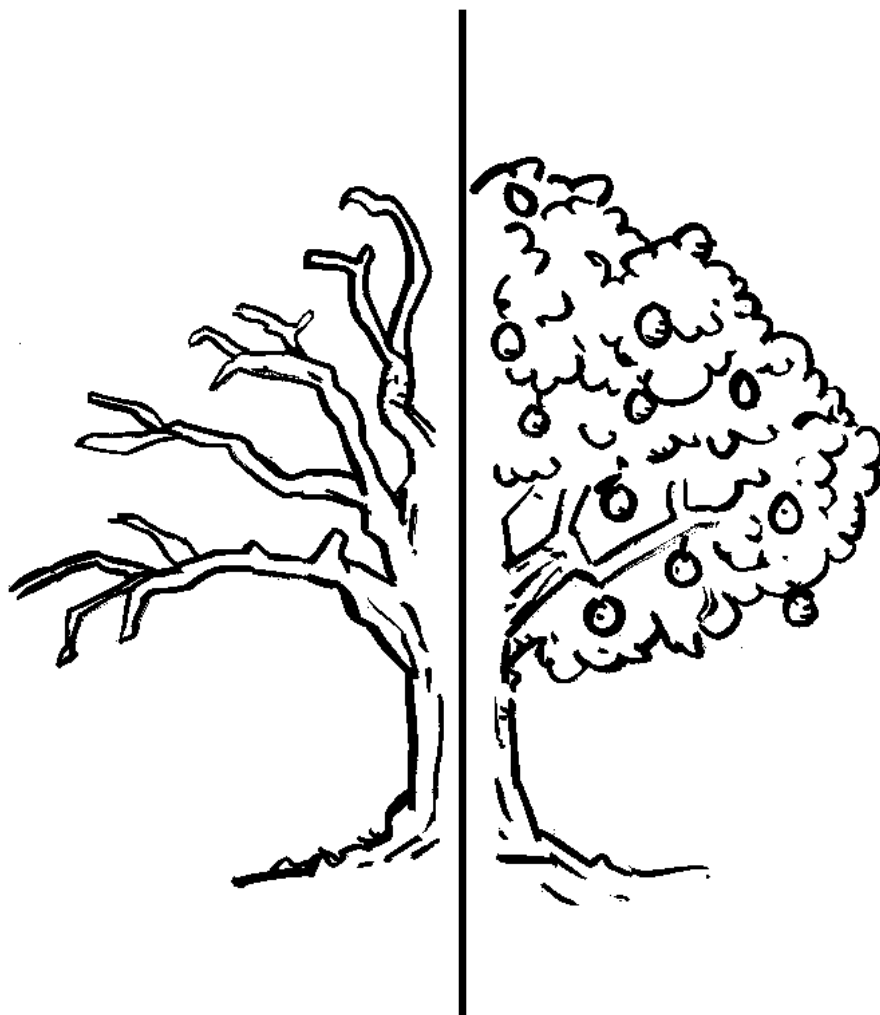
It is clear from this study that the proxy voting space for asset managers in South Africa is underdeveloped. There are very few sources of quality research relating to voting items and relatively little research is generated internally by AMs. Policy documents are typically weak and do not communicate effectively to clients, internal investment professionals or investee companies. The majority of managers appear to treat proxy voting as a box-ticking exercise, without giving thought to ways in which responsible voting can create value for clients.

However, there is a small number of AMs who do strive to leverage these opportunities effectively. Many of the personalities driving these strategies are involved in broader initiatives to focus investors’ minds on stewardship and responsible investing, like CRISA, which will hopefully reduce unnecessary risk-taking and improve the sustainability of client returns. South Africa was partially insulated from the crisis that has put the issue of stewardship under the magnifying glass of investors overseas; the sooner such initiatives bring this issue into focus locally, the better.

A new investment dynamic is emerging, in which genuinely active managers recognise the link that stewardship has with the welfare of their clients’ assets, not to mention with the society and environment within which they and their clients live. As these responsible institutional investors are shown over time to outperform the skeptics and cynics, investors locally will follow the international trend and move their assets to those who use their right to vote wisely.

Study participants

Abax Investments
Afena Capital
Allan Gray Limited
Argon Asset Management
Cadiz Asset Management
Coronation Fund Managers
Element Investment Managers
Investec Asset Management
Kagiso Asset Management
Mergence Investment Managers
Oasis Asset Management
Old Mutual Investment Group (South Africa)
Prudential Portfolio Managers
RMB Asset Management
Sanlam Investment Management
STANLIB Asset Management
Taquanta Asset Managers



“Fancy documents don’t count for anything unless the people in an organisation espouse the ethical values of the organisation.”

Useful resources

King III: <http://www.iodsa.co.za/en-us/productservices/kingiiiireportpapersguidelines/kingreportoncorporategovernanceinsa/kingiii.aspx>

CRISA: <http://www.iodsa.co.za/en-za/productservices/kingiiiireportpapersguidelines/codeforresponsibleinvestinginsacrisa.aspx>

ICGN: <http://www.icgn.org>

UNPRI: <http://www.unpri.org/>



Jimmy Winfield is a senior lecturer at the University of Cape Town, where he teaches courses in Business Ethics and Financial Reporting. He is a co-author of Understanding Financial Statements, a popular MBA textbook, and has written often about ethics for Accountancy SA. He can be contacted at jimmy.winfield@uct.ac.za

RisCura is a premier independent financial analytics provider and investment consultant with significant expertise in Africa. RisCura services institutional investors with over \$180 billion in assets under management. RisCura is the leading provider of independent valuation, risk and performance analysis services to investors in Africa.

RisCura has undertaken this research with external partners in order to better understand proxy voting in South Africa and gain greater insight into its use as a tool for investors in this market.

For more information, please contact **Malcolm Fair** at mfair@riscura.com or **(021) 673 6999**.

www.riscura.com

Sponsored by **RisCura**
good thinking