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Engaging with Rob Main of Vanguard

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CamberView Partners is pleased to present a new series of conversations with the people and organizations shaping the evolving investor landscape. This interview has been edited and condensed for clarity.

Chris Wightman: Tell us a bit about Vanguard's approach to Investment Stewardship.

Rob Main: At Vanguard, our long-term perspective informs every aspect of our Investment Stewardship program. The majority of our assets under management are in index funds, so we are practically permanent shareholders in almost every public company in which we are invested. That really affects the way we think about investment stewardship—from our advocacy efforts in the industry, to our engagement with companies, to our proxy voting. We believe that companies with strong, foundational governance practices are best positioned to achieve long-term success.

It's also important to us that issuers have robust disclosure of material risks so the market can properly value assets; we want a company's stock price to appropriately reflect the risks and opportunities of investing in the company. For our index funds, whose investing time horizon is essentially forever, the effect of poor disclosure becomes magnified over time. When your risk horizon is almost infinite, even low probability risks have the potential to become more certain.

Q: How many people are on the team heading into the 2018 proxy season? How are the team's responsibilities divided?

A: Our team has been very active over the past year. In the 2017 proxy season, our Investment Stewardship team voted over 171,000 individual ballot items on behalf of the Vanguard funds and held more than 950 individual discussions with portfolio company executives and directors.

We have a sector-based approach to analysis, engagement, and voting, which enables us to tackle an expanding array of corporate governance matters as relevant to the different industries across the market. The scope of our effort has doubled in size since 2015, and we now stand at more than 20 analysts, researchers, and operations team members. The team employs an iterative approach, researching and engaging on topics where we believe we can have meaningful impact. The team also monitors how our portfolio companies identify, manage, and mitigate risks—and how they identify and act on strategic opportunities—particularly those with material importance to value creation for investors. Ultimately, our voting decisions are also managed through this sector-based lens, which brings greater consistency and depth of knowledge for both our team and for companies.

Our internal research and communications function, which was built-out over the past year, helps us better communicate what we stand for, how we do our work, and the outcomes of our efforts on behalf of Vanguard fund shareholders. The team was key in developing our expanded Investment Stewardship 2017 Annual Report — which describes our full range of stewardship activities and provides some concrete examples of how we translate good governance principles into action. Going forward you can expect even more public communication about how we approach complex topics, and more visibility into how our research and philosophy translate into our dialogue with companies.

In addition to continued investments in our U. S. based engagement, voting, and communication efforts, this year we will establish a European Investment Stewardship team based in Vanguard's London office. One of our senior leaders will be re-locating to London to establish those efforts on the ground. That team will ultimately be responsible for oversight of our UK and European equity holdings—both in terms of our engagement and voting—and they will deepen our participation in local advocacy.

Q: When your team examines a company's corporate governance practices, what, in your view, are the critical elements for the board to get right?

A: We have four pillars that underpin our evaluation of companies' governance. We focus on enduring topics we believe will drive long-term wealth creation, rather than short-term results. These pillars guide our engagement with companies and our proxy voting:

1. **Board composition:** We believe good governance begins with a great board of directors, and we look to see that a company has a high-functioning, independent, diverse, and experienced board with effective ongoing evaluation practices. The board should be composed in a way that reflects the company's strategy of today and tomorrow, not years past.
2. **Governance structures:** We believe in the importance of governance structures that empower shareholders and ensure accountability of the board and management.
3. **Executive compensation:** We believe that compensation practices should appropriately incentivize sustained, relative outperformance.
4. **Oversight of risk and strategy:** Boards are responsible for effective oversight and governance of the long-term strategy and the material risks to each company.

Increasingly, boards' engagement in overseeing company strategy has been an area of interest. We view oversight of risk and strategy as two sides of the same coin: every risk can present opportunity, and every opportunity carries attendant risk. In recent years, there has been a greater expectation for boards to consult on the direction of strategy; we believe the board should be keenly attuned to a company's long-term opportunities and challenges, and should thoughtfully oversee how the company is moving forward. Some of the most highly engaged boards we meet are those who understand, inform, and guide the strategy—and at the same time actively manage the composition of their directors, ensuring the group is fit-for-purpose and well aligned to the strategic needs of the company.

Q: What is Vanguard's approach to engagement with portfolio companies?

A: Engagement is the bedrock of our Investment Stewardship program. It gives us the opportunity to learn about a company's long-term strategy and the alignment with its corporate governance practices. In general, we have three different types of engagements:

1. Some are **event-driven** in response to a specific situation or around shareholder meetings, especially when we are analyzing a contentious decision and therefore want to hear the company's or board's views of an issue.
2. Some engagements are **topic-driven**. For example, we might look at boards that have no gender diversity, and that could prompt us to engage with those companies' directors to better understand the board's approach to composition.
3. Increasingly, our engagements are more **strategic** in nature. A CEO we engaged with once said, "You can't wait to build a relationship until you need it," and that couldn't be more true. We want to understand a company's strategy and where they are headed, so that if the unexpected happens, we can put a situation in the appropriate context.

Q: How does the team prepare for a company engagement meeting? Who participates from the team?

A: We conduct significant research and analysis on a company, its governance, and the context in which it is operating to prepare for our engagements. The level and frequency of our discussions may be influenced by a number of factors, including the impact we believe we can have for each of our funds, and the contentiousness or time sensitivity of an issue. We believe that engagements provide an opportunity to better understand company practices and provide targeted and timely feedback to boards. We aim to provide constructive input that will, in our view, better position companies to deliver sustainable value over the long term.

Our senior strategists—who are senior leaders at Vanguard and lead each of our sector teams—oversee all engagement, analysis, and voting for the companies in their respective sectors. Most often, our senior strategists and their respective teams lead engagement discussions with companies; in select situations, they may include me or Glenn Booraem to bring an additional perspective to a discussion or voting decision. In rare instances, we may include members our Investment Stewardship Oversight Committee, which weighs in on a small number of particularly contentious votes and provides long-term direction on policy, strategy, and industry positioning for Vanguard broadly.

Q: How do you measure the success of your team's engagements?

A: Measuring the "success" of an individual point-in-time engagement can be more challenging than it sounds. We understand that, in some cases, meaningful change can take time for a company and its board, so we often measure the impact of our engagement over an extended period of time. In order to drive long-term results of our funds' investments, we want to build an understanding of a company's long-term strategy and their approach to governance; of course, we may weigh in with feedback over time if we see divergence from what we believe is best practice.

We also want portfolio companies to have a firm understanding of Vanguard's stewardship principles, our expectations, and how we make our engagement and voting decisions. Our ultimate goal is to enhance companies' behaviors around governance, risk mitigation, and strategic long-term value creation on behalf of their investors. So, in this very two-way and iterative communication process, neither side should ever be surprised by the other's actions on governance and stewardship.

Q: Are there any new topics that will be top of mind in 2018?

A: As you may have seen in our expanded 2017 Annual Report, and in Chairman Bill McNabb's open letter to boards, two areas of increased focus for our program are gender diversity on boards and climate risk disclosure. Importantly, our views on these topics are based in our belief that they can have a real impact on economics—not to drive a particular ideology.

There is no doubt that these topics have risen in prominence for many investors, including for Vanguard, as the body of research and analysis on each has grown. On the gender diversity side, there is compelling research demonstrating that greater representation of women on boards can have a meaningful impact on company performance and governance practices. On the climate risk disclosure side, our approach has evolved as the world and business community's understanding of the topic has matured. From an economic standpoint, it's important to us that all material risks to a business—including climate risk, if relevant—are disclosed so that the market can appropriately price a company's practices and assets.

Q: What does your team view as prominent industry trends in investment stewardship going into 2018?

A: For asset managers and institutional investors, we've noticed an increased focus on stewardship from clients. End investors are demanding more transparency and accountability into how asset managers are engaging and voting on their behalf, and firms are responding with enhanced approaches to focused communications through various channels. Our own expanded team is already helping us to better articulate our approach and activities to clients, portfolio companies, and the broader investment community.

For portfolio companies, one trend we've noticed is that no company is immune to activism or investor-driven disruption. Activist investors are no longer constrained by geography, market cap, or company reputation when choosing which company to target. Also, activists are making substantial investments in their targets. A company's good reputation, retail shareholder base, or a board filled with reputable directors no longer guarantees a shield from activist attention. Increasingly, institutional investors are evaluating the merits and credibility of both parties and their strategies for building long-term value. In addition to traditional activist investors, we are seeing more mainstream investors publicly challenge companies in their practices, whether through public letters or shareholder proposals. In each of these situations, we continue to take a holistic, thoughtful, and engagement-oriented approach to our analysis and voting.

Q: The two new wildcards of this year's proxy season for compensation will be the CEO pay ratio and changes to the tax deductibility of performance-based pay. How is Vanguard approaching those two topics?

A: I realize these two topics may create some noise this season. However, our process for evaluating executive compensation remains unchanged. We believe that relative performance-linked compensation policies are important contributors to long-term, sustainable value creation for a company's investors. We look to see that executive pay is aligned with long-term performance and reasonable in the context of peers and the broader market. When shareholders do well, so should executives; though, when companies underperform, executives' pay should move in the same direction. We also look to see that a company's disclosures show the alignment between pay and performance over time, and that the board is actively engaged in the compensation decision-making process. Our focus will remain on these areas in the years ahead.

Q: In recent years, activists have been increasingly successful at gaining board seats. How does Vanguard approach engaging with activists?

A: We take a balanced approach to our engagement with activists, as with any other stakeholders. We evaluate each situation on a case-by-case basis with the goal of getting to the best long-term outcome for our fund shareholders. We look to engage with both the activist and the company in an open dialogue, and we evaluate each side's case on its merits. Activists can sometimes raise legitimate questions and can create a sense of urgency at companies, which may be a healthy impetus for change. To earn our support, activists must make a strong strategic case for the changes they seek <u>and</u> back up their recommendations with capable director nominees. As context, our funds sided with incumbent boards in half of the proxy contests that went to a vote in the U. S. in the last year.

We believe that directors and boards that think like activists, or even solicit opinions from activist-like investors, are often in the best position to avoid unwanted activist interventions. They have a self-awareness of their strengths and weaknesses, giving them the opportunity to either correct shortcomings or provide appropriate perspectives to the long-term owners.

Q: In one sentence, describe Vanguard Investment Stewardship.

A: We serve as a voice for investors, advocating for effective governance and long-term value creation.