September 2018

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Engaging with Rakhi Kumar of State Street Global Advisors

Rakhi Kumar
State Street Global Advisors
Senior Managing Director, Head of ESG Investments and Asset Stewardship

Andrew Letts
CamberView Partners
Partner

CamberView Partners is pleased to present a series of conversations with the people and organizations shaping the evolving investor landscape

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Andrew Letts: Rakhi, thank you for taking the time to speak with us. Many of the people who will read this will be familiar with your team's work. We're hoping to take a deeper dive into how the investment stewardship team evaluates companies and the approaches you take. To start off, let's go back a few years. When I was at State Street Global Advisors, you and I did a lot of work together on the governance issues of the day, topics such as board tenure, executive compensation and sustainability. Since you took over the investment stewardship team in 2014, how would you characterize the evolution of State Street's approach to these issues?

Rakhi Kumar: The main evolution I would point to is that we have established a prioritization framework, where we take a risk-based approach to both sector and thematic reviews. We are trying to mitigate ESG risk in our portfolio and we are trying to be more active and focused about how we do that. In engagement, we talk about the topics we want to discuss and we speak with the issuers that we want to meet with – 85 percent of our engagements are proactive and about issues that are important to us.

I think the other main differentiator for State Street is that we share our views through thought leadership in which we aim to inform and improve ESG practices at our investee companies. We take difficult 'gray areas' in ESG such as effective board leadership or incorporating sustainability into strategy and try to provide a framework for companies and directors on how we as investors analyze these complex issues.

Andrew: We're right at the start of the fall off-season when companies, investors and proxy advisors are thinking about what's ahead for the coming year. What are the topics that are top of mind for you as we head into 2019?

Rakhi: During the off-season, we only engage on our priority issues, we don't engage for the sake of engagement. All of the consultations we'll have in the off-season will be centered around strategy. Long-term strategy is the starting point of any conversation. Within that, there are three areas we'll be focusing on: how are boards effectively helping management achieve their strategic goals, how are companies integrating sustainability into long-term strategic planning and how is compensation aligned to strategy.

Andrew: How effective are companies at engaging with State Street?

Rakhi: I think many companies are good at engaging, but it depends. We often have companies come to us with a deck made for every investor that doesn't include the business and strategic overview to contextualize those three elements I mentioned before. Many come with elements like a skills matrix which have boxes ticked on every director without the context of why those skills are important in the broader context of strategy.

Overall, companies need to understand that governance and sustainability can't be done in a vacuum – it is all linked to the business and strategy. A good engagement allows us to evaluate how the board operates and how the board oversees governance and sustainability in that context.

Andrew: What are you tired of seeing or hearing when you engage?

Rakhi: As a long-term investor, what is exhausting is when companies want to meet every year when there's nothing to discuss or when they know something is upcoming but they don't tell you and then want to speak to you again in-season. Another practice that some companies do is to not bring forward a director during proxy season and then after a bad vote, a director wants to hear what we have to say.

Andrew: Many companies view engagement and sitting down with investors on a regular cadence as a way to establish a relationship. How important or appreciated is that on the investor side?

Rakhi: I think it's important for investors to have a relationship with the companies they are invested in. We want to build a relationship with the board. On priority engagements, we ask to meet with the Lead Independent Director or the responsible board member because we're trying to hear what actions they are taking and because we think it's more impactful and responsive to raise issues at this level.

As we move to engaging more when there isn't a vote at hand, we like having a director on the call. These meetings are an opportunity for us to evaluate and get comfort with a director so that we can have a 'trust' lens as well. But, it's a two-way street – with engagement culture on the rise in the U.S., companies should be asking themselves 'what do we need to get out of this relationship?'

Andrew: Is it helpful for you to meet with a company that doesn't have any issues, but is best-in-class in terms of sustainability disclosure or processes?

Rakhi: We typically do that when we are taking on new thematic issues. For example, with supply chain management, we met in the first year with some of our top holders that we felt managed that issue well. They helped us understand the problem. Year two was about learning from those companies with strong practices and being able to evaluate companies who have different practices.

Here's an example: during our conversations about supply chain risk, someone told us it's actually ludicrous that anyone would know all the risk in their supply chain because it's so complex. The takeaway we had from that conversation was that if you have such a complex supply chain that you can't identify the risks, then maybe you need to simplify your supply chain. You may actually be creating more risk in the system.

This is one reason why we prioritize thought leadership, whether in our annual report or speaking to the broader market. We view it as a way to help educate companies and boards on what issues, concerns and approaches they should be considering.

Andrew: In State Street's recently-released annual stewardship report, you discuss that the investment stewardship team engaged with over 100 companies in 2017 on climate change. You also noted that few companies could effectively communicate how they integrate climate risk into their long-term strategy. What do you look to hear from a company or a director when you talk about that?

Rakhi: Through engagement we're trying to understand the impact of board discussion around climate change on long-term strategy and capital allocation. We frequently hear from directors that 'climate change is important, we debate it and discuss it' and that's often where the feedback stops.

Our question is – you discussed it, what were the results and actions from that discussion? That is where you start seeing how companies incorporate sustainability or climate change into strategy. If the result is no impact, that's fine, but it's important to know that it didn't change your thinking. Bottom line, you can't have that conversation without understanding the outcome of those discussions.

Andrew: Without naming names, what companies have knocked it out of the park in terms of explaining climate risk to you?

Rakhi: You see this more in Europe than in the U.S. In the U.S., companies are starting to talk about climate change but still defend their current strategy. The conversation seems to be that companies know investors want to talk about climate change, but when they are pushed on what they are doing about it, the answer tends to be 'it doesn't impact us'.

When European companies are telling us they are pivoting because of climate change, we have to ask what are they seeing that's so different – is it regulation or something else? They're all global companies – why are some companies reacting one way and others another way?

Andrew: Let's talk for a few minutes about your expanded role at State Street in driving ESG investing. One recurring theme in your stewardship report was how your work is tied into collaborative initiatives such as the Investor Stewardship Group (ISG). Which of the frameworks and organizations that are out there have been the most impactful on your work?

Rakhi: The Principles for Responsible Investment (PRI), the UK stewardship code and the ISG principles are the primary documents I would cite. In particular, I think the ISG is a very meaningful framework because it's the only way to establish minimum standards in the market given our regulatory system. This is a grassroots effort and it's still very early days for what the ISG can do, but it is a growing effort – we will be meeting in October to discuss membership and governance issues and ways to ensure that this group has more of a voice. The ISG principles are something that boards and the market more broadly need to understand because it is the best assessment for what investors expect at the minimum from issuers.

Andrew: From where you sit, how have you seen interest in ESG investing evolve?

Rakhi: Asset owner inquiries about what we're offering are on the rise. Different regions are on different paths but in general we're seeing ESG moving from 'thou shalt not do' something (like invest in sin stocks) to 'thou shall do something' (integrate ESG into my entire portfolio). That's because it isn't about ESG for the sake of ESG — it's the material risk posed by ESG.

As the long—term research continues to show that ESG helps from a risk/return perspective, we are going to see more growth in the demand for integrated ESG solutions. This is where the Sustainability Accounting Standards Board (SASB) comes in. They provide a materiality map, which is something companies need to learn about. It's surprising to me how many board members are not aware of SASB and the growing importance of ESG scores in driving investment. I would definitely say that from an ESG messaging perspective, ESG scores are going to be as important in driving investor dollars into shares as credit scores are for fixed income.

Andrew: So is SASB the solution or is there going to be another framework that overrides everything?

Rakhi: We think SASB is a significant part of the solution – it was developed by investors and has an investor perspective of ESG risks. The other framework is the Global Reporting Initiative (GRI), which looks at materiality from a stakeholder perspective focus. I think the one point that companies need to recognize is that while you can say that these frameworks are not perfect, whether its GRI or SASB, you have to start disclosing somewhere.

Andrew: Let's talk about activism – in recent years, State Street has discussed settlements in activist situations and expressed a viewpoint that companies should think about engaging with their investors to seek their opinion about the preferred course of action. Do you think that call has been heeded or is there room to do better?

Rakhi: By and large I think there's been a bit more noise around proxy contests this past year. However, I don't think it's had any impact on changing the terms and conditions of settlements. I think what it has done is companies will wait until the end and then, based on where votes are coming down, the contest will get settled. No one wants to take that public risk that they may lose. I feel like at least we're seeing a bit more pushback from management and more back and forth going on.

Andrew: When companies are in activist situations and are engaging with State Street, they are often looking for an indication from you about whether you are supportive of their side. What advice do you have for issuers looking for that kind of guidance or communication?

Rakhi: Let me step back a little bit by saying activism is no longer just about strategy. A few years ago we would say to companies — focus on strategy. But some recent activism situations have made clear that activists are becoming more sophisticated. It's not just about why one strategy isn't working, it's about telling us why the other strategies being proposed are not going to work in a changing environment. It's the board's job to recognize that, to do scenario planning and to be able to communicate why the alternative strategies are not right. I don't see that happening as effectively.

In some cases, we have companies coming in and asking us what to do. I think that's the board delegating its responsibility. The whole point of principal/agent is that we appointed directors because we don't have visibility into day-to-day operations.

Andrew: How do you view the growing trend of sustainability topics such as diversity being incorporated into activism and activists' theses?

Rakhi: To me, it's not just about being sustainable, it's about strategy. When it comes down to a proxy contest, strategy is number one because everything else can be changed. If a dissident says they don't have a woman on the board, that can be easily fixed by adding a woman.

One thing we don't give credence to is when people say they only took action because of an activist. As you used to tell me, sometimes activists do their job by showing up. I don't minimize making a change like adding a woman to a board because an activist shows up. Proxy advisors may knock that, but to me, the board was responsive and took action, so, hey, I'm happy.

Andrew: Tell us more about what's happening on the fixed income credit front – what is State Street's approach to integrating ESG into the fixed income process?

Rakhi: As an index investor, we get paid last, which means that we can't be agnostic of how the company is managing its long-term balance sheet. We've seen many instances of that happening and the classic example is in M&A activities. In one transaction, a company was looking to purchase another company, which pushed back and resulted in the acquirer taking on a lot of debt to pay for the acquisition. In a few years, a commodity cycle went belly up, they had too much debt and lost shareholder value.

That taught us we can't ignore the balance sheet when we're looking at a company. As an index investor, you can't say, for example, companies need to give me a dividend because eventually that decision will impact how much debt they're going to have and affect their ability to leverage up and down or do an M&A transaction at the opportune time. It's important to have a discussion at the board level about how they balance those needs because debt holders get paid before us.

Andrew: As a bondholder, you don't have the hammer of a voting right. How does that shape those conversations?

Rakhi: The conversations we've had are at the time when we make the decision to invest – that's when you have the most impact. ESG risks are as important to shareholders as they are to bondholders. Moody's and S&P are ramping up their ESG operations to further incorporate sustainability risks into their bond ratings – that's probably where this should be playing out.

In the absence of an annual vote, it's hard for bondholders to influence companies. But, we've had the fixed income team come in and ask questions during equity holder engagements and we've often found that while our PMs (who are long-only) and debtholders take different angles, they are concerned about the same things.

Andrew: Shifting to executive compensation, earlier this year State Street announced a new 'abstain' policy that would be a middle ground between 'for' or 'against' in say-on-pay votes. Did those votes achieve what you had hoped for or is it too early to tell?

Rakhi: Because of the new policy, our unqualified support for pay proposals has fallen in general. Overall unqualified support from a global perspective fell from 83 to 78 percent. In the U.S. there were 2,300 executive compensation votes — of that, 59 total votes (2.5%) were abstains, compared to 139 votes 'against' (6%).

Companies should view this as qualified support. The improvement here has been that it allows us to provide more transparency into the vote decision. I think it makes us better analysts because we're starting to go into the angles of what our comfort level is. It allows us to make a more nuanced vote decision instead of binary black and white. Its only 2 percent of votes, but those are difficult votes. The abstain gives us a greater ability to articulate our concerns and it has also been very helpful internally in improving the way we analyze votes.

Andrew: In situations where you are abstaining, do you let companies know that you expect changes?

Rakhi: To the extent that we are engaging with the company, we won't let them know how we'll vote but we do communicate what our concerns are. Like with companies where we withhold support, we will monitor responsiveness of the board to our vote.

Andrew: Last question, talk show host time – what is the most important thing that the person who is sitting in your seat in 20 years will need to think about?

Rakhi: The toughest question is who to hire. The demand for talent in this field is increasing — you need to have the right background in investments, business, and strategy and understand governance and environmental and social issues. I'm hoping it'll be an easier decision for that person but you're only as good as your team.

About CamberView Partners

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