African Review of Economics and Finance

African Review of Economics and Finance | ISSN 2042-1478 | Volume 9 | Issue 1 | June 2017

Opinion

The role of institutional investors in promoting long-term value creation: A South African perspective

Michael Harber

College of Accounting, University of Cape Town, Private Bag X3, Rondebosch 7701, South Africa.
Email: michael.harber@uct.ac.za

Abstract

"Short-termism" has been identified by many academics and business practitioners as a significant global problem in modern capitalist markets. The excessive focus of corporate decision-makers on short-term profit maximising goals, often at the expense of longer-term objectives, results in insufficient attention being paid to the strategy, fundamentals and the long-term value creation of an organisation. Agency theory provides a useful framework to begin to understand and address this problem, as it highlights the unaligned priorities of key stakeholders and decision-makers in capital markets. Institutional investor activism is a credible solution to short-term management behaviour and irresponsible shareholder pressures on management, because institutions usually hold significant interests in listed companies and have a vested interest in the long-term creation of corporate value. A substantial majority of the shareholding of most capital markets is owned by a concentrated group of mutual funds (collective investment schemes), pension plans, and other institutional investors such as hedge funds and medical aid schemes. Therefore the power to veto or at least control programs of raising dividends, increasing share buy-backs, spinning off company divisions and requesting board representation really sits with institutional investors and this is a fact that institutional asset managers need to acknowledge. The power and the responsibility to implement sound principles and practices of corporate governance sits with institutional investors. This paper explores the questions of how and why institutional investors need to exert more influence on the boards of the companies to which they are invested. Can institutional investors be held to a more long-term view

of corporate governance? What are the reasons for the failure of institutional investors to date? The South African context, including recent events in corporate South Africa, which includes the 2016 release of the King IV Report on Corporate Governance, are applied to the issue. South Africa can stand proud of its codes of good practice that promote responsible institutional shareholder activism.

1. Introduction

There has been a growing dissatisfaction internationally against corporate "short-termism", namely the concentration of company boards, especially large public-interest and listed entities, on short-term profit objectives at the expense of long-term value and wealth creation (Pozen, 2015). Short-termism is an excessive focus of decision-makers on short-term goals at the expense of longer-term objectives, resulting in insufficient attention being paid to the strategy, fundamentals and the long-term value creation of a firm or an institution (EY, 2014).

A 2003 survey performed of 401 senior financial executives in the United States explored the earnings benchmarks considered most important to the board of directors, as well as the factors which motivated them to deliver these earnings. The study found that the destruction of shareholder value through legal means is pervasive, perhaps even a regular occurrence in business decision making and the amount of value destroyed by companies striving to hit earnings targets exceeds the value lost in recent high-profile fraud cases. The majority of respondents reported that they would forgo current spending on profitable long-term projects to avoid missing earnings estimates for the upcoming quarter (Graham, Harvey, & Rajgopal, 2006).

Perhaps nowhere in recent corporate history are the damages of a managerial short-term profit seeking mind-set shown than in the circumstances that precipitated the 2008/9 global financial crisis. Large financial institutions were interested in selling as many loans as possible, creating an "originate-to distribute" model. The idea was to charge fees for giving credit, and then to use extremely complicated financial instruments in order to disperse the risk throughout the financial markets (the infamous collateralized debt obligation, CDOs). This gave incentive for banks to grant mortgages even to creditors unable to repay them (NINJA loans – "no income, no job and no assets", also known as sub-prime loans), all the while assuming an increasing house price market. Those responsible for granting loans were not so much interested in the quality as in the quantity of new mortgages, for which they were rewarded with bonuses. The financial markets started to act as if real estate prices would rise forever, loosening the creditworthiness criteria even further. The details of the sub-prime crisis and the following financial crisis are well documented today but needless to say, a moment was reached at which the consequences of short-termism became evident – the real estate bubble was about to burst. The exotic financial instruments that were backed by the crucial mortgage-based cash flows, suddenly became recognised as extremely risky and overvalued assets. This left banks with a huge amount of "toxic assets", raising the urgent need to repair their balance sheets, which required a significant tightening of credit criteria. This in turn adversely affected non-financial companies as the across-the-board credit crunch left many of them unable to finance their activity. As a result, the economic slump became more and more severe and was spreading around the world. All this was directly a result of managerial profit pursuit, without acknowledging the risks involved and the longer-term sustainability of the transactions. Ultimately the true cost was paid by the investing and tax-paying public.

As quoted by Martin (2015), Peter Drucker, a well known management consultant and author weighed in on the debate thirty years ago by saying in a Harvard Business Review editorial, "Everyone who has worked with American management can testify that the need to satisfy the pension fund manager's quest for higher earnings next quarter, together with the panicky fear of the raider, constantly pushes top managements toward decisions they know to be costly, if not suicidal, mistakes". However, Martin (2015) makes the point that some academics do debate whether short-termism even exists, and if it does, to what extent. The problem in coming to definite conclusions on the matter is that "there is no control group; we can't compare the performance of America with short-termism to that of America devoid of short-termism – or even prove beyond a doubt that short-termism exists in the first place" (Martin, 2015). This does make research on the issue particularly difficult.

This managerial short-termism, also described as the cutting long-term investments, such as research and development, in order to meet or beat short-term performance targets (Porter, 1992), has attracted increasing attention from researchers and practitioners in the last couple of decades. When one considers agency theory and the vested interests of executives, it is understandable why corporate "short-termism" exists and why it needs to be addressed. Management have goals that tend to be unaligned with other stakeholders, such as job security, salary increases, performance bonuses and share options to name but a few.

Management also has different aversion levels to risks in the organisation. The most common agency relationship of course is between shareholders (principal) and the company executives (agents). Agency theory is a well-researched area that is concerned with resolving these problems between principals and agents.

According to Eisenhardt (1989), agency theory emerged in the 1960s and 1970s from the combined disciplines of economics and institutional theory when economists explored risk sharing among individuals or group. Academics were concerned with resolving two key problems that can occur in agency relationships of principal and agent. The first is the agency problem that arises when (a) the desires or goals of the principal (e.g. a shareholder who desires long-term value creation) and an agent (e.g. management who want to maximise their current year performance bonus) conflict and (b) it is difficult or expensive for the principal to verify what the agent is actually doing (Eisenhardt, 1989). The problem here is that the principal cannot verify that the agent has behaved appropriately in furthering the principal's objectives and reason for hiring the agent. The second is the problem of risk sharing that arises when the principal and agent have different attitudes toward risk (Eisenhardt, 1989). The problem here is that the principal and the agent may prefer different actions because of the different risk preferences, for example the shareholder wants to act more conservatively to preserve and maintain operations sustainably over the long-term, whereby the company management are incentivised to take speculative bets in their decisions on the chance that profits in the period could be maximised. Hence we have the problem of managerial short-termism versus longer-term sustainable value creation.

However, it also needs to be acknowledged that not all shareholders are long-term investors and sometimes it is the shareholders themselves who can pressure management to make short-term profit-maximising decisions at the expense of the longer-term sustainability of the business. Pozen (2015) identifies activist hedge funds that acquire 1% or 2% of a company's shares and then push hard for measures designed to boost the stock price quickly but unsustainably, such as dividends increases, restructuring and share buy-backs. Rappaport (2005) explains the appeal that quarterly and annual profit announcements have in the mind of asset managers who manage millions of dollars of third party money in the form of pension funds and mutual-type funds (called unit trusts in South Africa). Agency theory may blame the misaligned incentives of management, but often it can also be certain activist shareholders who are also to blame for poor corporate governance and decision making.

Academics and business practitioners are therefore faced with some fundamentally important questions. Can institutional investors be held to a more long-term investment horizon? What corporate governance principles can be promoted to achieve this? What arguments can be provided in defence of shareholder activism to "focus on long-term value creation"? What strategies can management offer that will sustainably grow long-term value? Continual research to offer better solutions to these key questions is certainly needed.

2. The significance of institutional shareholders

So we can perhaps understand why company executives can have a short-term mind-set at the expense on longer term sustainability. Therefore, as the principles of good corporate governance now explain, responsible shareholders who seek longer-term value creation, need to hold management to account and implement appropriate incentives and controls to bring the alignment that agency theory suggests. Controls such as appropriate long-term performance incentive schemes (share options or share schemes with long vesting periods and performance criteria, for example), or suitably experienced and independent non-executive directors on the boards, led by an experienced and independent chairman.

However, these corporate governance principles are not always implemented properly and one of the primary reasons why is because of an apathy on behalf of shareholders in respect to monitoring management and holding them to account. A culprit who can be held especially to blame are the institutional shareholders, who usually account for the largest shareholding in large and listed companies. A substantial majority of the shareholding of most public companies in the United States is owned by a concentrated group of mutual funds, pension plans, and other institutional investors (Pozen, 2015). This situation is no different in other developed and developing economies. Institutions control the lion's share of company equity of stock markets and as such have the greatest potential to change this problem of managerial short-termism.

But why should institutional investors care about management short-term profit seeking? Why should institutional managers want to actively promote long-term sustainable value decision-making in the companies in which they invest? There are a few good answers to this question, not least of which is the reasoning that pension funds need to be able to make long-term investments that are designed to match the liabilities inherent in meeting pension fund mandates and obligations that stretch over many years. This is especially true for insurance products and defined benefit retirement funds. Given the long-term nature of the obligations and the interests of the third parties who own the funds, such as employees saving for retirement, institutional fund managers and their oversight bodies need to provide long-term growth of invested capital. Without such long-term growth, expectations and legal liabilities will not be met and therefore, in a real sense, institutions are obligated legally and ethically to deliver long-term sustainable value creation. Short-falls in meeting such obligations are born directly by the institutions themselves, or the organisations and individuals who provided the funds under management and mandated the institution to invest them with clearly defined objectives.

In addition to the above legal and ethical obligation to those who provide institutions with their money, institutional investors are often locked into the shareholding of most large companies on a long-term basis by the very nature of the investment business. Regulatory requirements, diversification and index investing (mostly based on market capitalisation or smart beta strategies) all contribute to the long-term nature of the shareholding and restrict large institutions from significantly reducing their holdings in a company. For example, if Company X Ltd. accounts for 7% of the top 100 companies on the Johannesburg Stock Exchange (JSE) by market capitalisation, then an index fund that tracks the top 100 companies must hold this share in this proportion for the long term. If a Company Y Ltd. is one of the largest mining companies on the exchange, then surely it would be very difficult for many resource-focused unit trusts not to take significant holdings in this company for the long term. The largest pension fund in South Africa, the Government Employees Pension Fund (GEPF) is the largest single shareholder in many JSE companies and this situation will not change in the medium to long term.

Thus institutional investors are long-term shareholders by nature, even if they do buy and sell on a regular basis, or lend their shares for a fee (called scrip lending). Due to these legal and practical restrictions, institutions have incentives to encourage good corporate governance that produces long-term value creation.

However, despite the above reasons for desiring long-term value creation, “short-termism” still seems to exist and significant efforts and engagement with institutional management is needed in order to promote better governance practices.

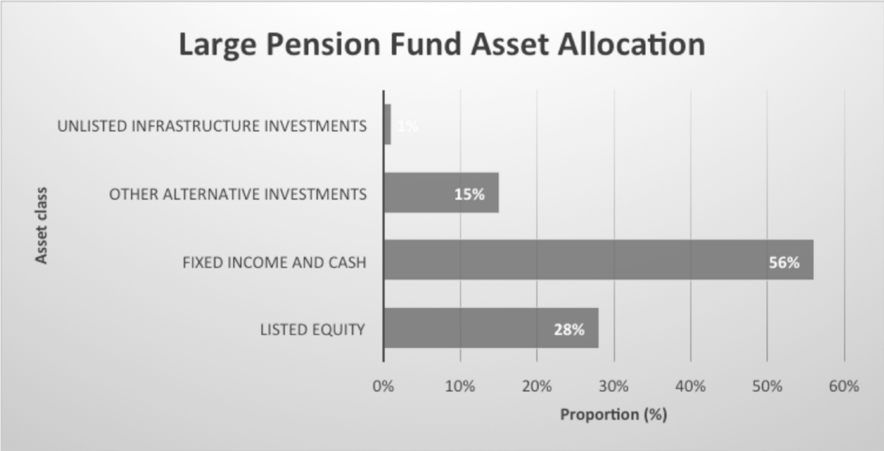
When asked to rank the most significant influences in the setting of company share price and in management’s development of earnings targets, institutional investors were ranked in the top two by over fifty percent of the respondents, with the second most significant influence being analysts. Individual investors were a distant third most important influence (Graham *et al*., 2006).

As already discussed, one of the important issues emerging from the 2008/9 global financial crisis is the alleged negative role played by institutional investors leading up to and during the crisis period (Callen & Fang, 2013). Many observers maintain that institutional investors exacerbated the crisis by pressuring the management of financial service companies for short-term profits and thereby increasing their risk-taking behaviour.

According to Rappaport (2005), most investment professionals recognise that the value of a company’s equity is best estimated through valuing the future cash flow produced by that company. However, the problem lies in the belief that estimating the more distant cash flows is too time-consuming, costly, and speculative to be useful. This, together with the fact that analysts have significantly less information about a company's strategies, operations and prospects than insiders do (i.e. management), analysts tend to attach substantial weight to reported short-term performance (Rappaport, 2005). According to Rappaport (2005), an obsession with short-term performance is the result and this comes at the expense of long-term value creation in the companies involved.

A survey performed in 2012 by the Organisation for Economic Co-operation and Development (OECD), across its 35 member countries, illustrates the role that large institutional investors can play in providing a source of stable long-term capital. The survey reviews trends in assets and asset allocation by 86 large pension funds and Public Pension Reserve Funds (PPRFs), which in total manage nearly USD 10 trillion in assets, more than one third of the total worldwide assets held by this class of institutional investors. Total assets managed by all types of institutional investors in OECD countries in 2012 was estimated to be USD 83 trillion, of this USD 22 trillion through pension funds. The average asset allocation by these institutional funds was found to be as follows:

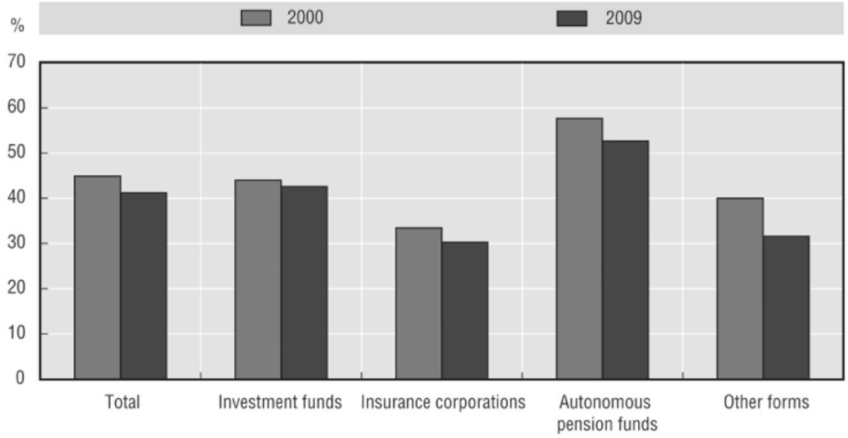
FIGURE 1: AVERAGE ASSET ALLOCATION



Source: OECD, Institutional Investors and Long-term Investment (2014)

A similar report by the OECD in 2011 provided the following proportion of total assets held as equity by institutional investor type:

FIGURE 2: EQUITY ASSETS BY TYPE OF INSTITUTIONAL ASSET OWNER



Source: OECD, The Role of Institutional Investors in Promoting Good Corporate Governance (2011)

It is therefore clear that institutional investors represent a major force in many capital markets. With the goal of optimising returns for targeted levels of risk, as well as for prudential regulation, institutional investors diversify investments into large portfolios, many of them having investments in thousands of companies (OECD, 2011).

Institutional investors are an obvious solution to irresponsible shareholder pressures on management, simply because institutions usually hold significant interests in listed companies. It is with this reality in mind that Laurence Fink, the CEO of BlackRock, the largest asset manager in the world, which manages over $4 trillion in assets, in February 2016 sent a letter to the chief executives of S&P 500 companies. In this letter Mr Fink warned company executives that they may be harming long-term value creation by capitulating to pressure from activist hedge funds to increase dividends and share buybacks. Executives were warned to resist "the powerful forces of short-termism afflicting corporate behaviour", urging them towards "working instead to invest in long-term growth" (Fink, 2016).

> "While we've heard strong support from corporate leaders for taking such a long-term view, many companies continue to engage in practices that may undermine their ability to invest for the future. Dividends paid out by S&P 500 companies in 2015 amounted to the highest proportion of their earnings since 2009. As of the end of the third quarter of 2015, buybacks were up 27% over 12 months. We certainly support returning excess cash to shareholders, but not at the expense of value-creating investment. We continue to urge companies to adopt balanced capital plans, appropriate for their respective industries, that support strategies for long-term growth." (Fink, 2016)

Do institutional investors usually take a stand either for or against proposals by activist minority shareholders? Warning against executives being unduly influenced by activist shareholders with short-term goals, Mr. Fink goes on to state in his letter:

> "Without clearly articulated plans, companies risk losing the faith of long-term investors. Companies also expose themselves to the pressures of investors focused on maximizing near-term profit at the expense of long-term value. Indeed, some short-term investors (and analysts) offer more compelling visions for companies than the companies themselves, allowing these perspectives to fill the void and build support for potentially destabilizing actions. Those activists who focus on long-term value creation sometimes do offer better strategies than management. In those cases, BlackRock's corporate governance team will support activist plans. During the 2015 proxy season, in the 18 largest U.S. proxy contests (as measured by market cap), BlackRock voted with activists 39% of the time." (Fink, 2016)

In the aftermath of the 2008-09 financial crisis where institutional investors were accused of placing undue pressure on financial service entities for short-term profitability, causing the management of these entities to pursue higher risk behaviour (Callen & Fang, 2013), even the European Union acknowledged the problem. The European Union officially stated that the financial crisis had undermined the assumption of institutional investors as responsible investors (The European Parliament, 2010). In strong and unequivocal terms the G20/OECD Principles of Corporate Governance, which were drafted in light of the 2008-09 financial crisis and the accusations against institutional investors, states in its foundational principles that:

> "the effectiveness and credibility of the entire corporate governance system and company oversight will… to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest." (OECD, 2011)

3. Opposing views: "monitoring" vs "short-termism"

According to Callen and Fang (2013), the literature provides essentially two opposing views with regard to institutional investor incentives and activities in corporate activism. These researchers label the opposing views as "monitoring" and "short-termism". The monitoring view argues that institutional shareholders, due to their large shareholding, have the incentive to actively monitor management and stay informed on corporate activity, since they stand to reap a greater reward for their efforts. Therefore these institutional shareholders monitor and discipline management in order to ensure that investment strategies promote longer term value creation. Literature is cited to show findings to this effect. However, Callen and Fang (2013) also cite literature that shows empirical evidence for the short-termism view, suggesting that institutional investors trade heavily on current earnings announcements, place excessive emphasis of short-term performance and fail to correct excessive CEO compensation. Many critics claim that, by acting as traders, institutional investors place excessive emphasis on short-term performance, causing management to be overly concerned that near-term earnings disappointments will induce heavy selling by institutional investors and the undervaluation of stock price (Callen & Fang, 2013; Manconi, Massa, & Ayako, 2012). In light of these mixed findings, the study by Callen and Fang (2013) supported the "monitoring" view.

4. Institutional reluctance

Are institutional investors perhaps giving lip service to long-term value creation while privately advocating for the more short-term agendas of minority shareholder activists? In their defence, there are many reasons, provided below, which could explain why these institutions are generally reluctant to be proactive in pushing for long-term reforms in company strategy at shareholder meetings. The following is a brief discussion of some of these reasons.

Reason 1: The nature of institutional investors has evolved over the years into a complex system of financial institutions and fund management companies with their own corporate governance issues and incentive structures. Conflicts of interest and misaligned performance incentives, especially regarding financial remuneration of institutions managers, can discourage the type of shareholder activism that promotes decisions that sacrifice short term profitability in pursuit of broader stakeholder needs and long-term value creation (OECD, 2011). According to Barton (2011), fund trustees, often advised by investment consultants, assess their institutional management performance relative to benchmark indices that encourage short-termism. Management compensation is linked to the amount of assets they manage, which typically rises when short-term performance is strong. Not surprisingly, then, management focus on such performance and pass this emphasis along to the companies in which they invest.

Reason 2: Many assets under management are held in index funds. Funds that track a market index or follow a smart beta strategy generally do not require analysts and managers with in-depth knowledge of the underlying companies. Over 30% of US stock assets under management are now held in index mutual funds or exchange-traded funds that are based on indexes (Udland, 2016). Hence, such index funds are not in a good position, or do not have the incentive, to analyse a shareholder activist's program for change. A 1993 survey of the 40 largest U.S. pension funds, 40 largest investment managers, and 20 largest charitable foundations indicated that while some index fund managers were highly active at shareholder meetings, most were completely passive (Useem, Bowman, Myatt, & Irvine, 1993).

Actively managed funds tend not to assert a strong position on either side of a voting proxy fight, unless doing so meets a cost-benefit test (Pozen, 1994). The cost of participation is high because it requires management time (the institution's management) and potential litigation.

Reason 3: The free-rider problem exists in that an activist incurs all the costs of the campaign to secure proxies, yet most of the benefits go to other shareholders who have not contributed to the efforts (Pozen, 2015).

Reason 4: A number of asset managers have effectively outsourced their research and voting decisions in public company elections to proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis. Do these outsourced organisations have a long-term perspective? According to a study on outsourced voting by advisory firms, four sizable asset managers disclosed that they uniformly follow the voting recommendations of one proxy adviser. These results suggested that this outsourcing appears to have the unintended economic consequence that boards of directors are induced to make choices that decrease shareholder value (Larcker, McCall, & Ormazabal, 2015).

Reason 5: Depending on the nature of the institution and the inherent incentives, fund managers are incentivised differently with respect to shareholder activism. For example, hedge funds frequently concentrate a large portion of their assets in relatively few company shares (Pozen, 2015). Hedge fund managers also often partake in significant performance fees linked to fund return. These characteristics do not exist for pension fund trustees or labour union representatives for example. Thus, the cost-to-benefit ratio in proxy fights is much better for the more concentrated funds in comparison to diversified mutual or pension funds.

Reason 6: Hedge funds can control a much higher percentage of proxy votes than their beneficial interest in the company's shares through a practice called "empty voting". For example, asset managers can lend their shares to a hedge fund and then not recall them for a contested proxy vote. Modern hedging techniques readily permit investors to separate ownership of the economic risks of shares from ownership of the right and ability to vote with those shares. As a result, activist investors (usually hedge funds) sometimes create large hedge positions solely to gain the vote, while avoiding economic exposure to the market. These empty voting positions are used solely to affect the outcome a shareholder vote (Nathan, 2007).

Reason 7: Since the costs of monitoring companies is high, as well as time consuming, especially considering the number of companies with which institutional funds invest, institutional investors may just sell off their shares and bonds in response to unfavourable performance rather than influencing corrective action (Manconi et al., 2012).

Reason 8: The strategy of many institutional investors is to diversify portfolio risk and maintain liquidity by investing in the equity of many different companies. This strategy may result in indifference regarding the governance of individual corporations and the incentive to ''walk away'' from influencing corporate activities rather than actively engage (Callen & Fang, 2013).

Considering the above incentives and realities of the investment management industry, can institutional investors be held to a more long-term view? What arguments can be provided in defence of Laurence Fink's call to shareholder activism to "focus on long-term value creation" and to engagement with management to "offer better strategies than management" that will sustainably grow long-term value?

5. Finding solutions

In light of the clear empirical evidence of short-term profit making decisions by company boards, many commentators and researchers express the same sentiment as Barton (2011), that "to break free of the tyranny of short-termism, we must start with those who provide capital" (Barton, 2011). Researchers and practitioners have argued that managerial short-termism can be alleviated by enhancing effective monitoring of company management to discourage narrow-minded and biased behaviour or by granting managers with long-term incentive compensation (Chen, Cheng, Lo, & Wang, 2012). Such approaches increase the expected costs of such short-term decision-making to managers and hopefully will prevent managers from engaging in it (Chen *et al.*, 2012). Recent research, such as that done by Duchin, Matsusaka and Ozbas (2010), that questions the overall effectiveness of board monitoring, highlights such concerns and makes a recommendation to promote oversight through placing independent non-executive directors on boards.

Barton (2011) makes the argument for three essential elements to promote the deep reform that is required by business to combat the damage caused by short-termism. There needs to be a fundamental shift in business, starting with firstly revamping managerial incentives and structures. Secondly, "executives must infuse their organizations with the perspective that serving the interests of all major stakeholders – employees, suppliers, customers, creditors, communities, the environment – is not at odds with the goal of maximizing corporate value" (Barton, 2011). Thirdly, shareholders must become more active and engaged in corporate governance and then make sure the board is empowered to govern like owners, rather than managers. This third point is particularly relevant to the role of the institutional investor in corporate governance and part of the answer suggested is what Barton (2011) calls "redefining shareholder democracy". Long-term shareholders, with long-term value creation objectives, need to recognise their responsibility to actively govern the companies that they have significant shareholding in. High shareholder turnover from increased speculative trading in the markets, which produce short holding periods and vote-buying practices, may even require standard setters and corporate governance bodies to reconsider the concept of "one share, one vote" principle of governance, at least in some circumstances (Barton, 2011).

Perhaps a partial answer lies in providing more voting power to those individuals and institutions who meet certain criteria that prove them to be long-term shareholders?

An interesting finding by Callen and Fang (2013) was that institutional ownership by public pension funds, as opposed to bank trusts, investment companies, and independent investment advisors, is significantly negatively associated with future crash risk, consistent with findings that pension funds more actively monitor management than other types of institutions. Surely then more active monitoring, which means active engagement in the governance of companies, promotes long-term value creation and sustainable operations? The findings of Callen and Fang (2013) advocate for more institutional involvement, and specifically of the kind being shown by large pension fund custodians. Other institutional managers should play close attention to findings such as these.

From the possible solutions provided above, it is clear that the answer to short-termism is mostly to be found in better corporate governance principles. Providers of capital need to be more active in controlling company activities. Remuneration of management needs to incentivise long-term objectives. Boards must have sufficient numbers of independent directors appointed by shareholders to keep management in check. The obligations, both legally and ethically, of shareholders and management need to be clearly communicated and understood. These are all key corporate governance issues that are to some degree explained and recommended in corporate governance codes around the world.

6. The South African context

Similar to other countries, the assets under management in equity by institutions such as asset managers, pension funds and insurers, is very significant relative to total funds invested. As an example, Coronation Fund Managers and Allan Gray represent the two largest equity asset management houses, as of March 2016, with total assets under management in the form of unit trusts of R240 billion and R237 billion respectively (Cairns, 2016). At this time total assets under management by Coronation Fund Managers was approximately R600 billion. According to the Association for Savings and Investments SA (ASISA), the total equity managed by its members in collective investments schemes, as of September 2016 was R368.5 billion, excluding foreign equity (Association for Savings and Investment South Africa (ASISA), 2016).

These figures are clearly very significant. The asset management industry in South Africa therefore surely bears a large degree of responsibility to fight short-termism in listed companies. Nevile Chester (2016), a senior member of the equity investment team at Coronation Fund Managers, outlined Coronation's commitment to responsible investing and actively engaging with management of the companies to which Coronation invests. According to Chester (2016):

> Coronation engages regularly with the boards and management of the companies it is invested in. All these engagements are documented to ensure detailed record-keeping and accountability for boards, as well as for investors to be fully informed as to how their investment is being exercised in the interests of good corporate governance.
>
> When there are specific concerns, our first approach is to engage with management to deal with the respective issues. If this fails to deliver the appropriate action, we then escalate the issue to the board. When governance issues emerge, we do not believe selling out of a company is an appropriate first response. This runs the risk of incurring losses on the investment, and fails to live up to the demands of being a good corporate citizen, who should strive to ensure that companies are applying the correct standards of governance for the protection of all investors.
>
> If we are not satisfied by the board's response, we will then exercise our rights as shareholders in a general meeting to vote in a way that ensures the board will listen to our governance concerns. Clients often ask why we typically are not seen to lodge opposing votes at AGMs – the reality is that we often engage extensively with boards and management well ahead of any votes. We want to ensure that our concerns are dealt with before the vote. It is only in those cases where the company refuses to take our suggestions on board, that we do end up voting against resolutions.
>
> In the event that all these interventions fail, we will look to remove board members who we believe are not exercising their fiduciary responsibilities in shareholders' interests. This is always the last resort and, given the reputational impact, not something that we do lightly. We will always approach the board and the individuals upfront and deal with this process in a professional manner. Ambushing directors at an AGM with a surprise vote is not in our opinion acting in investors' or the company's best interests.(Chester, 2016)

On the issue of proxy voting, Coronation also apparently "endeavors to vote on all shares in its portfolios. We report to clients on our voting record and the reasons for our positions on a regular basis." (Chester, 2016). Allan Gray make similar claims and provide public record (via their website) of their voting recommendations, together with the outcome of the shareholders' vote on each relevant resolution. These efforts are to be commended.

Does this happen in practice regularly? And if so, how many asset managers and other types of institutional investors are doing this?

A controversial example of what many have called responsible institutional activism, is the recent stand (August 2016) made by Futuregrowth Asset Management (owned by Old Mutual), Africa's largest specialist fixed-income money manager, to stop lending money to six of South Africa's largest state companies (Cohen, 2016). This decision caused significant media attention and major criticism from the South African government. What was the reason for this decision by the board of Futuregrowth? Simply put, they were concerned about how state companies were being run, government infighting and threats to the independence of the finance ministry, and they were not prepared to place client money at risk. Futuregrowth was clear that it would only resume offering loans and rolling over existing debt once it had determined that what it sees as proper oversight and governance has been restored (Cohen, 2016). It is encouraging to see an institution, which stands to lose a lot in the way of client funds and reputation, making a stand on behalf their clients and sending a message against perceived poor governance practices that can destroy value.

7. Recommendations of the King IV Report

The King IV Report on Corporate Governance in South Africa superseded the King III Report as of November 2016 when it was officially released by the King Committee and the Institute of Directors in Southern Africa (IoDSA). According to Professor Mervyn King SC, who is chairperson of the King Committee in South Africa, "the overarching objective of King IV is to make corporate governance more accessible and relevant to a wider range of organisations and to be the catalyst for a shift from a compliance-based mind-set to one that sees corporate governance as a lever for value creation" (IoDSA, 2016).

King IV, like its predecessor, emphasises the need for responsible corporate citizenship, stakeholder centric governance, long-term value creation and ethical leadership by those charged with governing organisations. And like its predecessor, its principles and recommendations, if applied by institutional investors and by company boards, will result in a real end to the problem of short-term profit seeking and value destruction.

However, King IV goes even further with regards to the responsibilities of institutional investors. Whereas the previous King reports were written from the perspective of the governing body as the focal point of corporate governance, King IV broadens the application to include institutional investor responsibilities (referred to as a fiduciary duty for an institutional investor). Of the 17 principles in the King IV Report (down from 75 in King III), one relates specifically to institutional investors. This illustrates the importance of responsible institutional activity in governing companies to which they have holdings.

According to principle 17 of King IV (the last principle), institutional investor governing bodies should ensure that responsible investment is practiced by the organisation to promote the good governance and the creation of value by the companies in which they invest (King IV IoDSA, 2016). They are to manage their rights, obligations, legitimate and reasonable needs, interests and expectations, as holders of beneficial interest in the securities of companies. One of the foundational concepts in Part 1 of King IV is shareholder activism and specific emphasis is made regarding the role of institutional investors, who should pursue "principles of responsible investment towards long-term, sustainable returns" and understand that the types of decisions they make and how they exercise their rights as shareholders, either reinforce or weaken good governance in the companies in which they invest" (King IV IoDSA, 2016).

As King IV reminds readers, these principles are already contained, in more detail, in the Code for Responsible Investing in South Africa (CRISA) issued in 2011. The CRISA provides in Principle 3 that "where appropriate, institutional investors should consider a collaborative approach to promote acceptance and implementation of the principles of this Code and other codes and standards applicable to institutional investors" (CRISA IoDSA, 2011). This correlates with the UN-backed Principles for Responsible Investment (PRI) launched in March 2006. These principles encourage collaborative engagement to better incorporate environmental, social and governance issues in decision-making and ownership practices.

The King IV Report even goes so far as to provide a sector supplement for retirement funds in order to provide high-level guidance and direction on how King IV could be interpreted and applied.

Other aspects of good corporate governance that seek to limit short-term profit seeking and create long-term value focus, remain key areas in the King

IV Report. Examples of such being board composition, director functions, sub-committee composition and function, and of course director remuneration. Remuneration principles remain a major focus in King IV Report with the guidance and recommended practices being further developed and refined. How much South African executives earn, and why, is an important focus of the King IV, which introduces the idea that executive pay should be "fair and responsible" in the context of overall employee pay.

South Africa can stand proud of its heritage of world class codes of good governance. The King IV Report will no doubt, like King III, be seen internationally as the benchmark guidance for corporate governance. The new JSE listing requirements, released for public comment in November 2016, will no doubt incorporate King IV. However, at the end of the day, the King IV is not legislation and remains a self-regulating document that does not enjoy the force of the law. Will institutional investors respond and improve their shareholder activism and improve the quality of corporate governance in South Africa? If short-termism persists, it surely won't be because of a lack of guidance. If short-termism persists, surely the problem lies elsewhere. I believe there is much scope for South African specific research on the role and the performance of institutional investors.

Biographical Notes

Michael Harber is a lecturer in Auditing and Corporate Governance Economics at University of Cape Town, South Africa. He is a chartered accountant CA(SA) and holds a Master's degree in Financial Management from the University of Cape Town. He is currently enrolled for a PhD in Auditing at the University of Johannesburg, South Africa. His research interests are focused on corporate governance and auditing.

References

Association for Savings and Investment South Africa (ASISA). (2016). Statistics on Collective Investment Schemes. Retrieved November 24, 2016, from https://www.asisa.org.za/en/statistics

Barton, D. (2011). Capitalism for the Long Term. *Harvard Business Review,* https://hbr.org/product/capitalism-for-the-long-term/R1103F-PDF-ENG

Cairns, P. (2016). Coronation still SA's biggest asset manager, but only just. *Moneyweb*, (May). Retrieved from http://www.moneyweb.co.za/investing/coronation-still-sas-biggest-asset-manager-just/

Callen, J., & Fang, X. (2013). Institutional investor stability and crash risk: Monitoring versus short-termism? *Journal of Banking & Finance Journal*, 37, pp. 3047-3063.

Chen, X., Cheng, Q., Lo, A. K., & Wang, X. (2012). CEO contractual protection and managerial short-termism. *London Business School Research Symposium. Research Collection School of Accountancy, 5*.

Chester, N. (2016). Responsible Investing. *Coronation Corospondent*, (January). Retrieved from http://www.coronation.com/za/personal/responsible-investing-january-2016

Cohen, M. (2016). Futuregrowth stands by loan freeze to SA state companies. *Bloomberg*. Retrieved from http://www.moneyweb.co.za/home-category/futuregrowth-stands-by-loan-freeze-to-sa-state-companies/

Duchin, R., Matsusaka, J. G., & Ozbas, O. (2010). When are outside directors effective? *Journal of Financial Economics*, 96(2), pp. 195-214.

Eisenhardt, K. M. (1989). Agency Theory : An Assessment and Review. *The Academy of Management Review*, 14(1), pp. 57-74.

EY. (2014). Short-termism in business: causes, mechanisms and consequences. Retrieved from http://www.ey.com/Publication/vwLUAssets/EY_Poland_Report/$FILE/Short-termism_raport_EY.pdf

Fink, L. (2016). 2016 Corporate Governance Letter to CEOs. *Business Insider*. Retrieved from http://www.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2

Gilson, R. J., & Gordon, J. N. (2013). The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights. *Columbia Law Review*, 113(4), pp. 863-927.

Graham, J. R., Harvey, C. R., & Rajgopal, S. (2006). Value Destruction and Financial Reporting Decisions. *Financial Analysts Journal*, 62(6), pp. 27-39.

IoDSA. (2011). *The Code for Responsible Investing in South Africa (CRISA): The Institute of Directors in Southern Africa*. Retrieved from http://www.iodsa.co.za/?page=CRISACode

IoDSA. (2016a). Governance in SA gets major update: The Institute of Directors in Southern Africa. Retrieved November 24, 2016, from http://www.iodsa.co.za/news/315704/Governance-in-SA-gets-major-update.htm

IoDSA. (2016b). *The King IV Report: The Institute of Directors in Southern Africa*. Retrieved from http://www.iodsa.co.za/

Larcker, D. F., McCall, A. L., & Ormazabal, G. (2015). Outsourcing Shareholder Voting to Proxy Advisory Firms. *The Journal of Law and Economics*, 58(1), pp. 173-204.

Manconi, A., Massa, M., & Ayako, Y. (2012). The role of institutional investors in propagating the crisis of 2007-2008. *Journal of Financial Economics*, 104(3), pp. 491-518.

Martin, R. L. (2015). Yes, Short-Termism Really Is a Problem. *Harvard Business Review*, (October).

Nathan, C. (2007). “Empty Voting” and Other Fault Lines Undermining Shareholder Democracy: The New Hunting Ground for Hedge Funds. *The Corporate Governance Advisor*, 15(1), pp. 1-9.

OECD. (2011). *The Role of Institutional Investors in Promoting Good Corporate Governance. OECD Publishing*. Retrieved from https://www.oecd.org/daf/ca/49081553.pdf

OECD. (2014). *Institutional Investors and Long-term Investment.* Retrieved from www.oecd.org/finance/OECD-LTI-project.pdf

Porter, M. (1992). Capital disadvantage: America’s failing capital investment system. *Harvard Business Review,* 70(5), pp. 65-82.

Pozen, R. C. (1994). Institutional investors: The reluctant activists. *Harvard Business Review*, 72(1), pp. 140-149.

Pozen, R. C. (2015). The Role of Institutional Investors in Curbing Corporate Short-Termism. Financial Analysts Journal, 71(5), pp. 10-12.

Rappaport, A. (2005). The economics of short-term performance obsession. *Financial Analysts Journal*, 61(3), pp. 65-79.

The European Parliament. (2010). *European Parliament resolution of 23 September 2008 with recommendations to the Commission on transparency of institutional investors.* Retrieved from http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2008-0426+0+DOC+XML+V0//EN#BKMD-18

Udland, M. (2016). The incredible rise of the $4 trillion equity index fund business. Retrieved November 23, 2016, from http://www.businessinsider.com/index-fund-assets-under-management-2016-1

Useem, M., Bowman, E. H., Myatt, J., & Irvine, C. W. (1993). US institutional investors look at corporate governance in the 1990s. *European Management Journal*, 11(2), pp. 175-189.