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Stewardship and Fiduciary Duties: The Spectrum of Pension Fund Engagement

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Abstract
A critical issue for the future growth of institutional investor Stewardship and engagement over investee companies is whether it is compatible with the fiduciary duties of pension fund trustees. This study examines how a range of interpretations of fiduciary duties informs approaches to corporate governance. Using the data from thirty-five in-depth interviews with key decision-makers I reveal that trustees understand their fiduciary duties in a variety of ways, which underpins the intensity and methods of engagement. Four distinct approaches emerge: Disengagement, Employer Engagement, Fund Manager Engagement and Corporate Engagement. I provide novel and empirically grounded explanations of much theorized but little understood concept of fiduciary duty in relation to corporate governance. The paper also has significant policy implications in that it raises scepticism about realising aspirations for shareowner Stewardship and fiduciary standards within the investment chain.

Keywords: Institutional Investor Stewardship; Pension Fund Ownership; Fiduciary Duty; Kay Report

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INTRODUCTION

The role and practices of institutional investors, and more specifically, shareholder engagement has been one of the central themes in ‘governance through ownership’ research for over seven decades (Daily, et al, 2003). Corporate ownership landscape is dominated by large-scale institutional investors like insurance companies, mutual funds and pension funds, which represent enormous pools of money invested in the stock market. According to the OECD pensions’ indicators (2013) in the UK pension fund assets as a share of GDP have reached 95.7% in 2011 while in the US this figure stood at 70.4%. Yet, ownership behaviour by pension funds is a little explored topic in corporate governance research.

Using pension funds as the example, the paper explores factors that shape pension fund ownership behaviour. More specifically, how a range of interpretations and enactments of trustee’s fiduciary duty in relation to a pension fund informs pension fund behaviour vis-à-vis portfolio companies. Debates about the place of institutional investors in an era of ‘new financial capitalism’ (Davis, 2008; Jackson, 2008) and policy calls for a shift towards investor stewardship (The Stewardship Code, 2010) and fiduciary standards, necessitating loyalty and prudence within the investment world (The Kay Review, 2012) provide the contemporary theoretical and practical backdrop to this study.

The paper provides novel empirical explanations to the much theorised debates about fiduciary duties in relation corporate governance issues (Sandberg, 2013) and gives answers to whether interpretations and enactments of pension fund trustee fiduciary duties are conducive to engaged share-ownership and long-term investment strategies.

The paper is structured as follows: it begins by reviewing the literature on corporate ownership, institutional investors and pension funds to highlight the mixed evidence of investor’s role in corporate governance and that investors’ behaviour has also been viewed through the dichotomous ‘exit/voice’ (Hirschman, 1970) or ‘owner/trader’ lens (Hendry, et. al, 2006). I argue that such conceptualisations are analytically unhelpful and not reflective of the current complexity of investor/company relationships. In order to move away from this dichotomy and account for the variety of positions and methods in respect of investor influence vis-à-vis corporations I utilise Martin, et. al.’s (2007) analytical schema of investor engagement as an initial conceptual platform for this study.

Following the discussion of the research design and process, I then draw on the qualitative data to demonstrate that Martin et al’s (2007) engagement framework cannot be fully applied to the case of pension funds because it does not explain how fiduciary duty, which is central to all trust-based pension schemes, shapes pension fund approaches to equity ownership. I reveal the variety of pension fund approaches to equity ownership, represented by the spectrum of engagement. Overall four distinct approaches emerge: Disengagement, Employer Company Engagement, Fund Manager Engagement and Corporate Engagement. I show that the variations in these approaches are explained by different meanings attached to the enactment of pension fund trustee fiduciary duties. It emerges that majority of trustees assume disengaged stance to equity ownership largely because trustees’ interpretation of their fiduciary duty to ‘act in the best interest’ (duty of loyalty) is interpreted as the duty to act in the best ‘financial’ interest of the members by seeking maximum returns on investment. Such interpretations raise scepticism about realising aspirations for shareowner Stewardship and fiduciary standards within the investment chain envisaged by the Stewardship Code (2010) and the most recent Kay Review (2012) because the
associated costs of engagement do not seem to justify the abstract benefits of stewardship and engagement. I conclude by considering the significance of these findings with respect to academic debates and offer some implications for further corporate governance research.

**INSTITUTIONAL OWNERSHIP AS A GOVERNANCE MECHANISM**

Since Berle and Means (1932) examined the implications of the separation of ownership and control, ownership behaviour by institutional investors has been given a significant role and provided a theoretical platform for a substantial body of research exploring the consequences of institutional investor equity ownership (David, Hitt & Gimeno, 2001). Agency theory, which has dominated the field of corporate governance research, provides a basic rationale for why institutional investors, as owners of corporate equity, should engage with firms (Jensen and Meckling, 1976; Fama and Jensen, 1983; Shleifer and Vishny, 1986; Leech and Leahy, 1991; Maug, 1998). The underlying assumption here is that the need to align the interests of managers (the agents) with those of investors (the principals) offers investors an incentive to monitor and participate in the company’s strategic direction (Mallin, 1994; Gillian and Starks, 2000; David, et. al., 2001; Hoskisson, et. al., 2002; Anabtawi, 2006; Johnson, et. al. 2010). For this reason, many scholars have argued that institutional investors may act and should act as engaged owners (Shleifer and Vishny, 1986; Huddart, 1993; Admati, et. al., 1994; Maug, 1998; and Noe, 2002). Debate and interest in institutional investor ownership as a mechanism of corporate governance has been given fresh emphasis in an era of ‘Financial Capitalism’, characterised by greater concentration of ownership in the hands of institutional investors such as insurance companies and pension funds and at the same time an observable lack of commitment vis-à-vis portfolio companies (Davis, 2008, Jackson, 2008).

Beyond academia, practitioners and policy-makers have also placed greater emphasis on institutional investors’ involvement in corporate governance. In the US this is evident from Conference Board reports (e.g. Tonello, 2006), whilst in the UK the financial crisis has served to heighten the expectations of policy-makers that institutional investors should act as stewards and engaged owners of shares (Ownership Commission, 2012; The Stewardship Code, 2010). The most recent Kay Report (2012) has been very critical of the way UK equity markets are geared towards generating short-term investment profits, emphasizing the need for a shift towards long-term and ‘fiduciary’ standards, necessitating loyalty and prudence within the investment world.

All in all, the current legal and regulatory environment of shareholder protection is seen to create receptive conditions for investors to get involved in corporate governance while the ‘soft’ codes place expectations on institutional investors to act not as shareholders but as shareowners. However, the existing empirical evidence of investor engagement is decidedly mixed (Bainbridge, 2003; Dalton, et. al., 2007; Tilba, 2011).

On the one hand, there is much written about investors actively engaging with investee companies. For example, in US and concentrating particularly on the relationship between institutional ownership and executive remuneration, Gillian and Starks (2000), Hartzell and Starks (2003), Watson Wyatt (2005) and Georgeson Shareholder (2005) indicate that some institutional investors are active in influencing executive compensation structures. Brandes, et. al. (2008) highlights that investors are
seeking to influence target firms’ policies, structure and governance. In the UK, Mallin (1994; 2010) and Crespi and Renneboog (2010) document the increased levels of investor voting. Aguilera, et. al. (2006) observe that UK investors increasingly get involved with their investee companies and concern themselves with issues such as board structure and effectiveness, executive remuneration, succession planning and corporate strategy.

On the other hand, the case is made that institutional investors tend to be distant and disengaged owners of equity. In the UK, while examining a randomly selected sample of 250 companies quoted on the London Stock Exchange between 1988-1993 Franks, et. al. (2001) indicate that holders of large share blocks exert little disciplining influence on the corporate management. Furthermore, Hendry, et. al. (2006) see institutional investors not as active ‘owners’ but primarily as financial ‘traders’ who happen to control key resources, as a result of their trading, but whose interests are divorced from those of long-term share owners. Both in the UK and the US Davis (2008) and Jackson (2008) observe an ‘ownership paradox’ whereby institutional investors seem to be growing in size and the concentration of their stakes, which gives them potential influence over managers, this concentrated ownership is liquid and without commitment. The financial crisis in 2007-2009 seems to further demonstrate investors’ lack of involvement in addressing poor corporate conduct.

These are interesting and potentially significant puzzles for our understanding of institutional investors’ ownership behaviour vis-à-vis investee companies. Furthermore, the mixed empirical evidence about investor activism also seems to be framed around dichotomous ‘exit/voice’ (Hirschman, 1970) or ‘owner/trader’ (Hendry, et. al. 2006) conceptualisations, which appears rather blunt and simplistic. What seems to be absent from the discussion and remain unclear is how this ‘owner/trader’ behaviour can be observed and explained. As holders of shares and suppliers of scarce and valued capital resources on which single firms are dependent for survival, institutional investors potentially have the power to influence their investee companies. Yet, prior research does not reveal more of the tapestry of institutional detail and a variety of influence positions vis-à-vis investee corporations. Conceptually, is there a possibility for a more nuanced categorisation of investor ownership behaviour? I suggest that explaining investor ownership behaviour and assessing whether investor Stewardship is realistic and feasible, would be more reflective of the complex empirical reality through the lens of engagement.

**Institutional Investor Engagement**

Martin, et al (2007) defines investor engagement as ‘the use of residual control rights by investors to influence the management process of a given portfolio company’ (p.19). The authors develop a framework of engagement practices, which fall between indirect and direct control. Within the framework, investor engagement is aimed at improving corporate management practises and in so doing enhancing corporate performance and shareholder wealth.

The framework incorporates five approaches: indirect/laissez-faire, external, internal, negotiatory and direct engagement. Each of these approaches involves distinctive means of monitoring and disciplining corporate managers. At the minimum, *Laissez-Faire Engagement* characterizes distant, arm’s length financial arrangements where investors concede strategic and operational control to corporate management (their agents). Discipline is exercised by exit, threat of exit or capital withdrawal. Moving away from the distant and minimalistic approach to equity
management, *External Engagement* assumes that investors intervene to protect the workings of mechanisms of control through the capital market, without becoming involved in the internal operations of the firm. Discipline is exercised occasionally through shareholder resolutions. *Internal Engagement* sees investors influencing the internal governance of the firm through the appointment of independent, non-executive directors, leaving the board to carry out its responsibilities to maximize shareholder value. *Negotiatory Engagement* involves investors discussing strategic and occasionally operational matters with corporate management. Influence is exercised through persuasion, reinforced by financial pressures (long-term funding arrangements through banks and corporate network allies). *Direct Engagement* involves dominant block holders who are able to control management directly through hiring and firing company’s management. The maximum form of engagement involves active intervention in the development and implementation of corporate strategy through meetings, voting, shareholder’s resolutions at the AGMs, requesting EGMs and joining forces with other investors to exert pressure on the company.

All in all, Martin et. al’s (2007) classification of engagement represents a more fruitful conceptual lens to explain investor behaviour. Notwithstanding, I will proceed to demonstrate that it cannot be fully applied to a specific case of pension funds, where trust-based fiduciary duty is central in informing pension funds’ approaches to stewardship and engagement. Although Martin et. al’s (2007) suggest that it is important to consider substantial distinctions in the character and conduct of investors, the framework represents broadly a ‘typical’ investor case and does not differentiate between investor types, which is crucial in explaining the investment behaviour (Aguilera and Jackson, 2003; Judge, et al, 2010).

To fill this knowledge gap, I focus on pension funds and develop a model, which outlines a spectrum of engagement, which shows how trustees’ interpretations of their fiduciary duties inform various approaches to equity ownership and stewardship. In so doing I also identify new forms of engagement, specific to pension funds, which do not figure in Martin et. al’s (2007) work.

**RESEARCH CONTEXT: THE CASE OF UK PENSION FUNDS**

Although UK pension funds may no longer be the largest investors in the UK equities since their allocations have been steadily falling from 61.1% in 2006 to 46.4% in 2010 and 35.1% in 2013 (The Purple Book, 2013), pension funds are particularly significant for stewardship because they seem to be designed to generate investment returns over longer-term and their investment approach (in theory) ought to reflect this (Ryan and Schneider, 2002; Davis, Lukomnik, & Pitt-Watson, 2006; Martin, et al. 2007). Through equity ownership pension funds potentially are in a position to play a significant role in the evolution of UK ownership (Franks, Mayer and Rossi, 2005), yet there remain few studies in relation to pension funds and corporate governance, some of which yield conflicting results.

In the most recent study on UK pension fund ownership Tilba and McNulty (2013) find evidence of both engaged and disengaged approaches where interdependencies and gaps of accountability within the investment chain predispose most pension funds to investment short-termism and disengagement. Although the authors explain some of the drivers of pension fund investment behaviour, their analysis focusses more on the relationships within the investment chain and as such it cannot be complete without providing explanations to the crucial pensions’ concept of ‘trust’ encapsulated by the fiduciary duty in relation to stewardship.
The Trust and Fiduciary Duties

Latin verb ‘Fiduciary’ means ‘to trust’ (Sandberg, 2013). UK pension funds originate from the Trust tradition, which dates back over 800 years. Under the Trust law pension fund trustees are entrusted with managing the assets for the individuals who could not adequately do so themselves. In other words, the trust is designed to protect the vulnerable when others have discretionary power to act on their behalf (The Law Commission, 2013). Thus, fiduciary duty requires ‘the duty of loyalty’ and ‘the duty of care’ where trustees are given a central role (Sandberg, 2013).

A year-long Kay Review of UK equity markets (2012) had criticized investment short-termism, which had dominated the market. Professor Kay considered that investment chains were too long with growing number of intermediaries between an investor and the investee company. A remedy to investment short-termism arose from his recommendation that ‘all participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers’.

However, is it unclear if this normative prescription holds any promise of investment behaviour change towards stewardship because as a concept ‘fiduciary duty’ is highly flexible, loose and uncertain. Sandberg (2011; 2013) suggests that it seems to be understood and enacted by practitioners in a variety of ways. There is a case to be made that the explanation of difference in approach to equity ownership, stewardship and engagement lays in different meanings and interpretations that pension fund trustees assign to their fiduciary duties.

RESEARCH DESIGN AND METHODS

In the interest of research rigor and transparency this section explains the aim and rationale for the study; the research methods used; the sampling of pension funds; the process of gaining access; how the data were recorded and how the data were analyzed.

Data Sources

The interviewee sample was generated from the UK Top 100 pension funds by the size of assets because, arguably it is the biggest and well-resourced pension funds that would be in a position to engage with the investee companies. All interviewees were selected with careful consideration of their professional role and the expected contribution to the research project. Data collection resulted in 35 in-depth, semi-structured interviews with pension fund trustees, executives, investment officers and investment intermediaries. All interviews were digitally recorded, transcribed and uploaded into NVivo for subsequent analysis. Martin et al.’s (2007) forms of engagement served as a way to open up the discussions around pension funds approaches to equity ownership and corporate engagement.

Data Analysis

The process of data analysis began in June 2013 and was inductive and interpretative and involved recoding the initial findings and thoughts on the emerging themes, discussing it with pensions, investment, legal and policy experts, going back to the interviews and identifying the key research themes and findings.

Content analysis was used to analyse the interview transcripts. Content analysis is a research method that examines the content of communication. Savall, et. al. (2008)
note that the robustness of content analysis depends on the reliability of the techniques used and the validity of the results. To warrant the robustness and the good quality of this data analysis, I used the techniques similar to those used by Dacin, et. al. (2010) and Tilba and McNulty (2013), which consisted of a series of steps. I used NVivo9, a qualitative research software, which assisted and facilitated the analysis of my interview data.

In the first step of the analysis, interview transcripts, entered in NVivo as text files, were coded on the basis of ‘in vivo’ words. These comprised phrases, terms, or descriptions offered by interviewees, all revolving around pension fund investment management and covering the initial research questions. Such descriptions included comments on pension fund characteristics, investment processes, roles and duties of strategic investment decision-makers. These formed the first-order codes. Altogether I had 611 coded passages at the end of this process.

The second step of the analysis involved looking for codes across interviews that could be developed into second-order codes. For example, comments on the first – order code such as pension fund investment management could be further grouped into codes or ‘tree nodes’ labelled ‘Investment Trends’, ‘Asset Allocation’, ‘Equities Management’. The interview passages discussing particularly pension fund engagement were then grouped under a ‘sub-node’ labelled ‘Pension Fund Engagement’. Following Lincoln and Guba’s (1985) recommendations, the second-order codes were then refined through triangulation of interviews with documentary analysis to produce a set of higher-level nodes.

The third step of the analysis involved looking for links between second-order codes and higher-level nodes so that I could collapse these into theoretically distinct themes. For example, ‘Pension Fund Engagement’ was further grouped into nodes labelled ‘methods’, ‘issues’, ‘meanings’, ‘examples’, ‘challenges’, ‘fund manager mandates’. This was a recursive rather than a linear process; I moved iteratively between the first- and second-order codes and the emerging patterns in the data until adequate conceptual themes emerged (Eisenhardt, 1989; Dacin, et. al., 2010).

The fourth step of the analysis involved organizing the emerging conceptual themes into the overarching dimensions that eventually underpinned the key findings and theorizing. Four dimensions of pension fund engagement strongly emerged here: Disengagement; Corporate Sponsor Engagement; Fund Manager Engagement; Direct Corporate Engagement. NVivo allowed the interview content to be analysed more systematically by using codes, keywords, word frequencies, reference counts, quantifying theme coverage and theme cross-comparisons. I also aimed to ensure that during the interpretation, the data are linked with the research questions and concepts and there is a close fit between the data and the research claims (Easterby-Smith, et. al., 2008). To help improve the accuracy of information respondents’ feedback was also sought because only the research participants can legitimately assess the credibility of the results (Lincoln and Guba, 1985). Usually this was done during the interview process by reiterating the respondent’s statements to make sure the intended message was understood correctly.

**RESEARCH FINDINGS**

One of the key observations this study makes is that pension funds engage with investee corporations in a variety of ways, underpinned by a distinction of either distance or a degree of involvement. Operationalizing Martin, et. al’s (2007)
conceptual framework of investor engagement I consider pension fund ownership behaviour against different interpretations of trustee fiduciary duty and make the following observations.

Firstly, there is a variation in pension fund approach to equity ownership. Pension funds can be seen as positioned along the analytical spectrum of engagement, where some pension funds seek to exert more influence than others over investee companies. A Disengaged approach to equity ownership is positioned at the extreme minimalistic end of the spectrum, is contrasted with Corporate Engagement at the extreme involved end of the spectrum. Between the two extreme forms in the model, are a corporate Employer Engagement and Fund Manager Engagement.

Secondly and significantly, the forms of engagement are largely informed by trustees understanding and interpretation of their fiduciary duty, which also takes different forms. In the case of Disengaged pension funds trustees understand their fiduciary duty primarily as the duty to act in the best financial interests of the pension fund members. In contrast, where Corporate Engagement happens it is also informed by trustee’s understanding of their ‘duty of care’, which extends to environmental, social and corporate governance issues.

Thirdly within corporate Employer Engagement, the duty of loyalty is broadly interpreted to mean acting in the best financial interests but also meaning that the duty of care extends to considering economic well-being of their sponsoring company, prompting engagement in the governance of their employer rather than investment portfolio companies. In the case of Fund Manager Engagement, trustees see it as their duty to maximize the investment returns but also engage with the fund managers in order to improve corporate governance of their investment portfolio for the financial benefits of pension fund members. It appears that the most meaningful strategic engagement is rare and happens ‘behind closed doors’.

Finally, positioning the data along the analytical spectrum of engagement suggests that most pension funds do not have a direct contact with their investee corporations and are disengaged. In this form, engagement is delegated to the outside investment managers and their mandates are overwhelmingly oriented towards producing the investment returns.

The main findings are offered with the introduction of the spectrum of pension fund engagement presented in Figure 1, which relates different interpretations of fiduciary duties to forms of engagement. I use this Figure as a guide and a reference point to present and explain the findings, starting first, with the majority of distant Disengaged pension funds.
Figure 1. The Spectrum of Pension Fund Engagement

Disengagement

I find that overall pattern of pension fund behaviour towards equity investment is Disengaged. Positioned at the very minimalistic end of the spectrum, this form of equity ownership resonates with Martin et al’s (2007) Laissez-Faire investor engagement, which assumes that pension delegate all to do with equity management to their external investment fund managers and focus the fund manager mandates on investment performance. Out of 35 interviews undertaken for this study, 22 interviews suggest that majority of pension funds do not have direct relationships with their investee companies, nor do they seek to influence their fund managers in any way when it comes to corporate governance or ESG issues. Moreover, there appears to be very limited monitoring and no clear prescription about what engagement policy should look like and how it should be effectively communicated to the fund managers. In practice, involvement either with the investee companies or with the fund managers on the issues of corporate governance is minimal.

Significantly, disengaged approach to equity ownership is informed by trustees’ understanding of the purpose of the trust and what the trustees duties are in relation to that trust. Trustees and fund executives consider that pension funds are there to provide financial security to members. A trustee’s duty in relation to the trust is to ensure that pension fund assets are invested in a way to secure the financial interests
of pension fund members. This predominant view was summarised by one trustee in the following way:

‘Coming back to basics, a trustee has got to act in the members’ best interest – that’s just a principal trust law and that’s extended in the pension’s law context to say that trustees have got to act in the members best financial interest... you’ve got to promise that the person will get his final salary on his retirement and that there is enough money there, because you promised to pay it’.

Another trustee of a pension fund with assets under management around £2.3 billion echoes this view:

‘We’ve always taken a view that we’ve got fiduciary duty, which is to get the appropriate level of return to meet our liabilities going forward, so we don’t take account all those ESG issues, we don’t screen on that basis’

A Pensions Policy Manager within one of UK largest pension funds with assets under management exceeding £30 billion explains the role of the pension fund ‘trust’ and related duties in their investment decision-making in the following:

‘The trust has been given, so if you are a trustee on a board you don’t fiddle with the terms of the trust, you actually deliver the trust and the trust says that you pay a pension of X to somebody, while you made sure the investments are made wisely in order to pay that benefit to that person, so our trustee board is doing just that. You have to just deliver the trust you have been given’.

All in all, the core fiduciary duty of loyalty to act in the best interests of pension fund members is broadly understood by trustees as acting in the best financial interests, i.e. the trustee’s role in relation to the trust is to deliver and pay benefits when they fall due to the members of the scheme. Although trustee’s fiduciary duty gives the trustees a fair amount of discretion in making investment decisions, provided they do it in good faith and take on appropriate investment advice, the common perception was that engagement was simply not something that trustees supposed to be doing. Furthermore, spending money on engagement was also considered ‘unjustified’ use of pension fund’s resources because of the perceived lack of evidence about the ‘immediate benefits’ of engagement.

Employer Engagement

Employer Engagement does not figure within Martin, et. al.’s (2007) conceptual framework because this form of engagement is specific to occupational pension funds. It is a peculiar form of engagement because it assumes that pension funds can be both distant and involved in corporate governance. On the one hand, pension funds have very little interest in how their portfolio companies are governed, delegating investment management to external fund managers. At the same time, these schemes pay significant attention to governance of their own corporate sponsor. In this form of engagement, a lot of corporate governance discussions between trustees and the senior managers are routine and are taking place ‘behind the scenes’, involving
dialogue about the overall strategic direction of the company rather than structural governance issues like remuneration or the board structure.

Involvement with an employer means working towards a better and more financially secure future for the company. In turn, this means fulfilling fiduciary duty by ensuring a strong and steady flow of pension contributions, which is in the interests of the pension fund members and the fund. In other words, engaging with the corporate sponsor is seen as part of trustees’ duty of care to secure employer’s contributions and in so doing to grow the fund. Disengagement with portfolio companies appears to be the enactment of the duty of loyalty to protect the financial interests of the fund members by focusing on investment performance of the investment managers rather than the individual investee firms. As trustee of one industry wide pension fund with assets under management exceeding £22 billion explains:

‘As a trustee one of my first and foremost duties is to ensure that there are adequate funds to pay the benefits to the members for as long as the benefits are due to be paid. In order to achieve that you have to look at the strength of the sponsor of the company. One of the huge influences on the strength of our sponsor is the fact that we’ve got this guarantee of continuing business for the next 25 years.’

Interviewees explain that the reputation and the strength of the corporate sponsor, or ‘employer’s covenant’, is key, particularly when it comes to weighting up the value of the pension promise that the employer has made to its members. Similarly to disengaged funds, majority of respondents within this form considered themselves as not being in a position to influence ‘other’ companies because the shareholdings in individual companies were small and represented only a ‘vehicle for delivering revenues’ needed to pay out pensions to members.

**Fund Manager Engagement**

While Martin, et. al. (2007) characterizes fund manager engagement as external engagement, suggesting that investors simply rely on the capital market as a disciplining mechanism, I find that in the case of pension funds, this form relates not to pension funds’ activity vis-à-vis investee corporations directly, but pension funds engaging ‘one level down’ - at the fund manager level. Here, pension funds put pressure on their fund managers (through the mandate) to engage with the investee companies on pension fund’s behalf.

While a fund manager is expected to produce returns on investment, the manager is also expected to exercise share ownership rights by voting, using either pension fund guidelines or guidelines of other industry organizations, primarily Pension Investment Research Consultants (PIRC) or the National Association of Pension Funds (NAPF). As shown in Figure 1, predominantly local authority pension funds are associated with this form of engagement. Eight local authority and three occupational pension fund interviews reveal that local authority pension funds exert more pressure on their fund managers because they themselves are under the public scrutiny and demand for greater transparency, particularly when it comes to disclosing of voting policies.

Pension fund engagement with the investment fund managers is largely informed by how trustees and pensions’ executives interpret their roles and duties. Interviews
indicate that in the eyes of trustees, pension funds, as institutional investors, should not only focus on paying out pensions but also act as responsible owners of shares by exerting influence on the investee corporations through their investment fund managers. Trustees value higher standards of corporate governance as a way to safeguard against poor performance and believing that more responsible ownership would benefit the scheme’s members in the long-term. A trustee from a local authority pension fund (£ 5 billion) encapsulates this view:

‘Motivation to engage with the managers was to recognize that pension funds were investing a great deal of money and shouldn’t be complacent about what is going on in the underlying investments. Governance does go to value and you know if a company is being properly run according to good standards actually that should be in our best interests anyway because ultimately it should go to value’.

All in all, the discussions with trustees about their fiduciary duties indicate that by engaging with the investment fund managers trustees broadly fulfil their duty of loyalty to act in the best financial interests of the pension fund members, but ‘stretching’ those interests to include non-financial (ESG) interests as means of enhancing the value of pension fund investment and the value of a pension fund.

**Corporate Engagement**

Within this study, only two occupational and local authority pension funds represented by the Local Authority Pension Fund Forum (LAPFF) directly engaged with investee companies by conducting company research and monitoring, voting and proxy voting, writing letters, and holding face-to-face meetings with senior management and boards of directors about structural and strategic corporate governance issues. These pension funds also invested in specialist corporate governance teams in-house or worked with external industry bodies such as PIRC, RImetrics or NAPF. Martin, et. al. (2007) associate such engagement methods with the Negotiatory form of engagement. In discussing governance issues with senior managers, pension fund respondents gave preference to the more subtle and routine conversations ‘behind the scenes’ and ‘trying to create and maintain long-term relationships with the companies’.

One underlying motivation behind engagement relates to trustees considering that engagement adds value and produces better financial returns for the pension fund. Since better investment performance is in the best financial interests of the members, engagement becomes part of trustees’ fiduciary duty of loyalty. For example, an Executive Member of LAPFF and a trustee of a pension fund with assets under management of over £3 billion highlights that engagement:

‘...adds value. It is not just altruistic...it is actually good business...there is evidence that it does add value to your shares...as much as 8% to the company value...It probably adds 20%, which is a lot’.

The other motivation relates to trustees’ personal values and sense of altruism and responsibility that resonate with being a responsible owner of shares, providing not only capital but also concerned with environmental, social and governance issues
for the greater good of society. The more altruistic stance towards engagement is more evident in the local authority pension fund context. One of the reasons for such ‘concentration’ of responsible investment interests within the public sector pension funds could be the fact that the local authorities are more pressured to have higher standards of public accountability and more is expected of these funds in terms of wider social, environmental and corporate governance issues. As a local authority pension fund CEO (£2 billion) explains:

‘We are a public sector body. In our day-to-day dealings good corporate governance, transparency with the public is key in everything we do, so we are applying that rationale to the pension fund... we have real high standards of public accountability and we just believe that that should run through our investments and if we get a chance through that investment to influence – we should be doing it’

Just by virtue of being in public sector, local authority pension funds appear to stand out in their attempts to integrate social responsibility into their investment practice. The local authority pension fund trustees ‘feel that they have a duty’ to engage with their investee companies due to their political and ideological principles.

DISCUSSION

Researchers have observed changing patterns of UK corporate ownership, characterized by the rise of institutional investors as an important class of shareholders (Mallin, et. al., 2005). Many corporate governance scholars highlight institutional investors, including pension funds, as a significant governance mechanism for lessening agency conflicts of interest (Shleifer and Vishny, 1986; Leech and Leahy 1991; Huddart, 1993; Admati, et. al., 1994; Maug, 1998; and Noe, 2002). Coincidentally, regulators and policy-makers are also concerned about the roles that institutional investors do play and should play in corporate governance (The Stewardship Code, 2010; The Kay Review, 2012). However, despite heightened interest in investor role in corporate governance, the evidence of investor engagement is mixed and theorisation about investor ownership behaviour seems to be rooted in a simplistic and dichotomous conceptualisation of either ‘exit/voice’ (Hirschman, 1970) or ‘owner/trader’ (Hendry, et. al, 2006) frameworks. The findings of this study suggest that problematisation of theory of ownership expressed through ‘exit/voice’ or ‘owner/trader’ lens is limited in capturing the complexity of institutional investor landscape and therefore inadequate in explaining current complexity within relationships between investors, their financial intermediaries and companies.

This study moves away from the simplistic categorisation of investor behaviour and uses Martin, et al. (2007) framework of investor engagement as a way to operationalise the concept of ‘stewardship’ and also applying this framework to a specific case of pension funds. Martin, et. al. (2007) have offered a way to re-conceptualise investor behaviour and account for a variety of positions and influence methods that may exist vis-à-vis investee corporations. However, their framework broadly depicts a ‘typical’ investor, which does not fit the specific case of pension funds because the framework does not explain how trust-based fiduciary duty is informing pension funds’ approaches to stewardship and engagement. I reveal that trustees understand and enact their fiduciary duties in a variety of ways and that largely informs pension fund approaches to equity ownership and stewardship. This
has allowed this study to put forward a more detailed conceptualisation of pension fund approaches to equity management.

Through the Spectrum of Engagement I demonstrate how the intensity of engagement is related to how trustees sometimes ‘stretch’ the meaning of fiduciary duty from the very minimalistic idea of acting solely in the best financial interests by focusing on generating investment returns to considering other factors such as the welfare of the employer and other environmental, social and governance factors. This study also identifies new forms of engagement, specific to pension funds, which mean different things to trustees and do not figure in Martin et. al’s (2007) framework. I also explain which of these approaches to equity ownership is most appropriate under which conditions. For example, Employer Engagement is a peculiar form of engagement, specific only to pension funds. It assumes that trustees can be both distant and involved in corporate governance. Although, trustees consider their duty to engage with the sponsoring employer because that would mean looking after the interests of both current and future members, pension funds associated with this form of engagement also act as distant and passive investors, delegating all to do with equities management to their fund manager and focusing their mandates on generating investment performance. In this way, ‘acting in the best interests’ assumes financial interests and generating best returns on investment to ensure that pensions are paid out. Although Employer Engagement seems to be very involved form of strategic engagement, it cannot be placed at the maximum end of the spectrum because it only assumes involvement with the parent company, where pension funds are being disengaged vis-à-vis other corporate stock held in other companies.

Similarly, while Martin, et. al. (2007) characterizes Fund Manager Engagement as external engagement, suggesting that investors simply rely on the capital market as a disciplining mechanism, I find that in the case of pension funds, this form relates not to pension funds’ influencing corporations directly, but through their investment fund managers. This happens because trustees believe that their duty in relation to the trust ‘stretches’ to include stewardship activities vis-à-vis companies they own on the stock market. Furthermore, Martin et. al., (2007) also suggest that through Internal Engagement investors may influence the internal governance of the firm by appointing independent and non-executive directors, leaving the board to carry out its responsibilities to maximize shareholder value. In the case of pension funds, I did not find any evidence of such engagement practices.

This paper also provides novel empirical insights into theoretical debate on the nature of fiduciary duty Sandberg (2011; 2013). This literature review notes that as a concept ‘fiduciary duty’ is highly flexible, loose and uncertain. Sandberg (2011; 2013) suggests that it seems to be understood and enacted by practitioners in a variety of ways. However, no empirical evidence has either confirmed or disproved this idea. By focusing on trustee roles, the study offers an empirically grounded explanation of how fiduciary duty is interpreted by the actors concerned and how it informs pension funds’ approach to equity ownership and engagement. Therefore, my research also helps explain why the literature on pension fund engagement has uncovered inconsistent results.

**Policy Implications**

The paper has significant policy implications. The Kay Review (2012) has proposed a concept of fiduciary duty as a remedy to fix investment short-termism within financial markets by requiring that ‘all participants in the equity investment
chain should observe fiduciary standards in their relationships with their clients and customers’ (Principal 5). This study shows that this approach is problematic at best. Using the concept of fiduciary duty and applying it in a legal sense is unrealistic because it is a very fuzzy concept, which is understood and enacted in different ways by trustees.

My empirical evidence of the variations in interpretations of trustees’ fiduciary duties and the subsequent differences in pension fund approaches to equity ownership and stewardship suggest that, in practice, there is confusion and uncertainty within the law and further clarification of the current law is needed, particularly if there is evidence to suggest that UK pension fund trustees believe that the law precludes them from ‘unjustifiably’ spending pension fund resources on engagement and considering non-financial factors. The law does not oblige ‘best interests’ to be interpreted solely in terms of financial best interests, but allows trustees to take a broader approach, provided that this does not compromise the purpose of the trust. Trustees need to be fully aware of that especially in the light of my findings that most pension funds are primarily associated with Disengagement.

The change in ownership behaviour towards long-term and more responsible investment is not likely to be achieved through simply applying a vague construct of fiduciary duty. The application of fiduciary duty becomes even more complex as we go along the investment chain of intermediaries.

CONCLUSION

This study is a contribution to a sparse empirical literature on pension funds and their role in corporate governance. It reframes the analysis of institutional investor behaviour away from a dichotomy of ‘exit’ or ‘voice’ (Hirschman, 1970), ‘owners’ or ‘traders’ (Hendry, et al, 2006) towards a richer conceptualisation of pension fund approaches to equity ownership informed by fiduciary duty and expressed through a spectrum of pension fund engagement. Given the present context of governance reform and the current emphasis on stewardship by institutional investors this study also sets out new avenues for future governance research, particularly in terms of institutional investor accountability. If we are to address the conflicts between what is in the interests of institutional investors and the ultimate beneficiaries and the interests of the firms in which they invest in, we need to pay more attention to the position of the pension fund trustee, in its capacity as a fiduciary, vis-a-vis the fund beneficiaries.

References:


