Investors: Getting To Know You And Your Governance

by Bill McNabb

Vanguard Group is the largest mutual fund in the world—but how often does your company and your board communicate with them on issues of interest to investors? According to Vanguard CEO Bill McNabb, public companies are remarkably shy when it comes to talking with the investors who own them. This reticence hurts both the companies and the investors whose confidence they must gain.

Let me begin by stating a simple belief that I have: *Corporate governance should not be a mystery.* For corporate boards, it should not be a mystery the way large investors vote their shares. For investors, it should not be a mystery the way corporate boards govern their companies.

We are moving in a direction where there is less mystery on both sides, but each still has some work to do in how they tell their respective stories. An anecdote from our company, The Vanguard Group, is illustrative of some of the headwinds that we all face in our efforts to improve governance.

A couple of years ago, we engaged with a very large firm on the West Coast. We had some specific concerns about a proposal that was coming to a vote, and told them so. The proposal failed, and it was embarrassing for the firm. They responded by reaching out for feedback from all their largest shareholders—or so they said. They never called their largest independent shareholder, Vanguard, nor did they apparently take into account the very specific feedback we had already provided.

In subsequent conversations with them (once we finally got to the board), they essentially told us, "You guys run index funds. We didn't think that you cared." Yes, we do care, and we care a great deal.

Let me offer some additional context for Vanguard's point of view. Today we are the largest mutual fund firm in the world. We have $3 trillion in assets under management. We have 160 funds in the U.S. and an additional 120 in markets outside the U.S. In the U.S., we have nearly $1.5 trillion in index equities—and an additional $330 billion in actively managed equity funds.

As indexers, we are *permanent shareholders.* To borrow a phrase from Warren Buffet: Our favorite holding period is forever. We are going to hold your stock when you hit your quarterly earnings target—and will hold it when you do not. We will hold your stock if we like you—and if we do not. We are going to hold your stock when everyone else is piling in—and when everyone else is running for the exits.

We as shareholders are not there, so the board needs to be our eyes and ears. Every other protective measure exists in case we fail to get the right people in the room.

That is precisely why we care so much about good governance. Vanguard funds hold companies in perpetuity, and we want to see our investments grow over the long term. We are not interested in managing the companies that we invest in. We cannot and do not. However, we do want to provide oversight and input on the board of directors. We count on boards to oversee management.

This perspective informs our approach to corporate governance. Our specific principles include:

☐ *Independent oversight, and appropriate board composition.* This is the single most important factor in good governance. We are in a representative democracy. We empower a group of people to

Bill McNabb *is chairman and chief executive officer of The Vanguard Group, Inc. This commentary is adapted from a speech that Mr. McNabb delivered at the University of Delaware's Weinberg Center for Corporate Governance in October 2014. [www.vanguard.com]* oversee our interests as shareholders, hire and fire the CEO, and have a say in strategy, risk oversight, compensation, and so forth.

We as shareholders are not there, so the board needs to be our eyes and ears. Who they are, how they interact, and what skills they bring to the table are critical from a long-term value standpoint. Every other protective measure exists in case we fail to get the right people in the room.

☐ *Accountability.* Management should be accountable to the board. The board should be accountable to shareholders.

☐ *Shareholder voting rights that are consistent with economic interests.* This means one share, one vote. No special share classes for added voting power.

☐ *Annual director elections and minimal anti-takeover devices.* We believe that shareholders benefit when the market for corporate control functions freely.

☐ *Sensible compensation tied to performance.* The majority of executive pay should be tied to long-term shareholder value.

☐ *Engagement.* Engagement serves as a touch point for all of our other core principles.

At Vanguard, we have been on a journey toward increased engagement over the past decade or so. Our peers in the mutual fund industry have as well. This is not poker, so our votes should not come as a surprise to companies and their boards.

Engagement must be more than just investors voicing concerns or publishing proxy guidelines. There are great examples of boards actively getting their messages out to investors.

Our outreach efforts began many years ago by simply posting our proxy voting guidelines on our website, then having *ad hoc,* issue-driven conversations with companies. A few years later, my predecessor as CEO, Jack Brennan, began writing letters to companies alerting them to the fact that we were a significant shareholder, and wanted them to be aware of our guidelines. Over time, we became more targeted in whom we mailed letters to, and more prescriptive in our language.

Last year, we sent out 923 letters (in total) to companies across the U.S., with 358 of those letters requesting specific governance structure changes. We told the companies that we differed on specific points, explained our stance, and described the direction we wanted to see the companies take. Finally, we added that we would love to discuss these issues with them further.

So far, about 80 of these companies have attempted to make changes. Some will fail in their attempts because the management proposal will not pass. We have had some very good conversations with other companies as well.

☐ ***Engagement is bilateral.*** Engagement is also a two-way street. It must be more than just investors voicing concerns or publishing proxy guidelines. There are some great examples of boards actively getting their messages out to investors. Sometimes it is event driven.

Microsoft, for example, has used videos from their directors to communicate the board's perspective on issues. It may be the lead independent director describing the board's role in overseeing strategy, or the chair of the audit committee describing the board's perspective on risk management. These insights into the board's thinking provide helpful context for investors. This is a great example of "one-to-many" engagement that is simple, underutilized, and very much appreciated by us as investors.

Another example is Dell Computer. When Dell announced its intention to go private, we met with the special committee of the board that had to make the decision on shareholders' behalf to sell at a specific price. We listened to their perspective and their decision-making process and the things that they took into account. This put us in a better position to decide whether or not this was a good deal. Such opportunities to interact with directors in the normal course of business give us increasing levels of insight.

☐ ***Engagement and board composition.*** Sometimes engagement simply means being crystal clear and transparent about your expectations, and how you think through certain issues. This applies to boards and investors. I would like to highlight two recent examples as it applies to board composition.

First, on the board side, there was Shelly Lazarus, who sits on the board of General Electric. Last year, GE published a "skills matrix" that spelled out the types of expertise or perspectives that they seek for their board. We see an increasing number of companies offering this kind of perspective, which is very helpful to investors.

Second, from the investor side, there is Rakhi Kumar, who leads corporate governance at State Street Global Advisors. State Street has announced a framework for assessing board tenure. They determined the average board tenure (in aggregate and at the individual level), and they said companies that exceed certain targets are more likely to be voted against.

For example, if a board has a director that exceeds State Street's tolerance, it is conceivable that Vanguard, BlackRock and Fidelity might also have similar questions about why, for example, a particular board member has served for 30 years, and whether he or she is sufficiently independent of management.

Open discussion helps boards that are comprised differently from other firms in their sector explain why to investors.

These are both great frameworks for raising important questions and prompting meaningful discussion between boards and investors. In the end, it facilitates a level of self-awareness for boards. It allows them to say that they realize their board is comprised differently (or operates differently) than other firms in their sector, and explain why.

There may be a good reason for a board to be an outlier—there may not. In either case, they can provide as much context as possible and invite discussion. Investors are going have these questions anyway, and in the absence of additional context, they will draw their own conclusions.

☐ ***Thinking like an activist.*** The "outlier" concept extends beyond board composition, and gets into matters of business oversight and strategy. I believe that the best boards continuously and purposely work to understand where their companies might be different, or might be perceived as different.

Are those differences strengths or vulnerabilities? Some of this difference is the continued evolution of the board's role in strategy. In many companies, we see the board's role moving beyond the historical perspective of "review and concur" to become more engaged in setting the strategy.

This raises an important question: How does the board inform itself? If you want to, as a director, you can be fed a steady diet of management's perspective on issues. In many instances, if left to your own devices, that is just what you get. Management comes in, gives you a presentation, and tells you why this is the right strategy. If that is what you accept, shame on you.

Healthy, vibrant boards *think like an activist,* in the very best sense. They ask, where should we be pushing harder or taking costs out? What are the blind spots of the management team? What are the blind spots on our board, and how do we correct them? Some boards bring in sell-side analysts that have a "sell" rating on the company to tell them what they are missing.

If all the board hears is management's perspective, they may be surprised when an activist shows up and says, "Hey, your cost structure is way out of line with your competitors!"

Today, we are seeing a greater trend toward *constructive* activists rather than destructive activists. They often raise legitimate questions.

The nature of activist investing has changed significantly since the 1980s. Today, we are seeing a greater trend toward *constructive* activists rather than destructive activists. Activists are not inherently good or bad. They often raise legitimate questions.

When activists raise legitimate questions, and tie their business cases to long-term shareholder value, that gets our attention. There have been a number of cases where a board did not ask the right questions, and eventually lost touch with how the company was being run, and how it was being perceived by investors.

☐ ***Looking ahead: The future of engagement.*** We count on you, as board members of public companies, to oversee the companies that our clients invest in. This is an important role. In the U.S. alone, Vanguard invests in the stock of some 3,800 publicly traded companies. We place a great deal of trust and confidence in you, and trust and confidence built upon open communication. We want to continue to increase the levels of engagement we have with boards. We believe that directors (and investors) are both moving in the right direction on that front.

As we look ahead, I believe we can do more. We have been involved in an effort to create the *Shareholder-Director Exchange,* which provides a protocol and some tools and guidelines for institutional investors and directors to talk. This is a wonderful idea, and has great promise. From our perspective, every positive change that we can help to effect is a win for our investors.

Another possible channel that I am passionate about is the creation of standing *shareholder relations committees* on public boards. This could be an incredibly effective way for boards to gather outside perspectives. Frankly, we are surprised that more boards are not soliciting our views on general industry topics.

For example, I would think that the directors of pharmaceutical firms or biotech firms would be interested in talking to our health care fund manager to hear her opinions and outlook for the industry. There is a great opportunity for (non-material) dialogue between investor and director on that level as well.

You, as directors, have a great opportunity to tell us how you bring value to investors. We want to listen. When you post a video to the company's website, we will watch it. When you give a good explanation of an issue in your proxy statement, we read it very carefully. When you provide context, we take it in.

We are listening to your perspective, and want you to be aware of ours. We are your permanent investors, and we care very deeply about the role that you play for our clients. ■