ACTIVE VIEWPOINT

MARTIN CURRIE AUSTRALIA

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SIX WAYS TO ASSESS IF A BOARD IS COMPETENT AND ON OUR SIDE

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GOOD GOVERNANCE IS NOT A FAD

While governance quality is a hot topic of late, we see it is one of the longest-term dynamics between markets, management and a company's fortunes. It is critical to a stock's performance in the long term.

But what does good governance look like and how can it be assessed externally? This can be a tough question compared with other more tangible steps in an investment process.

At Martin Currie Australia, we have created a governance analysis framework to assess red flags, and a thorough proxy voting process to put our findings into action.

> **Governance assessments are inherently difficult, but we see our framework for understanding good governance and assessing red flags as an important tool to cutting through the narrow collective thinking of boards and media reports.**

1. INDUSTRY EXPERTISE MATTERS

Assessing a board's skills matrix is a critical first step to our goal of determining if the board is competent and on our side as shareholders.

Boards must approve major strategic initiatives in what can be complex business landscapes. Diversity of thought matters, but so does expertise in understanding the nuance and detail of what is being decided.

At this stage, it is not just the directors' track records at the company in question, but across all board and management roles past and present.

2. PAST INDICATORS OF FUTURE POOR JUDGEMENT

It is not just whether someone has experience at large complex organisations, it's also whether they have demonstrated a positive contribution there.

In our experience, governance problems often come down to judgement, and we believe previous mistakes or bad decisions serve as the best indicator of poor judgement in the future.

We keep abreast of issues that have occurred across all of the boards that directors are and have been involved in. These include, for example, scandals, debt problems, rights issues, and misaligned compensation structures.

We are forward-looking in our approach. However, when we assess board quality, and have experienced poor oversight and governance from a particular director in the past, we find there is often little reason to forgive and forget. Company directors are often at the 'experienced' or more 'evolved' end of their career, so their nature is unlikely to change.

3. OVER-LOADED AND OVER-BOARDED

Workload of a director matters. Not from a prescriptive box ticking view, but as an indicator of the focus and attention they can afford to each of their roles.

According to data from corporate governance watchdog Ownerships Matters[1], of the circa 3,500 directors on boards of ASX listed companies:

- one has seven positions;
- six have five positions;
- 44 have four positions; and
- 145 have three positions.

We are particularly concerned about over-boarding when its combined with a poor grasp of company or industry details and prior examples of poor oversight, as we have seen a correlation between this and red flags.

4. BAD RELATIONSHIP MANAGEMENT

We don't wish to define the nature of the relationship between the board and management, but there are certainly good and bad practises.

Some boards dig deep in their oversight of the company. They get involved in strategy setting, have relationships with management at every level, and also talk to competitors and customers for alternative perspectives.

This model is often reflected in companies controlled by founders (but also brings different governance issues). This oversight model is appealing to those who come from a management view and demonstrates accountability but may blur the lines between what management has achieved versus the board.

A board can also appoint a first-rate CEO who creates a great management team with all the required expertise. The board takes responsibility for the quality and outcomes of the CEO and clearly holds them accountable via remuneration and tenure.

We are not prescriptive about the model, but if we see a board with a poor grasp of the issues inside a company, we need to be assured there is high accountability and a high-quality management team.

5. QUESTIONABLE ACCOUNTABILITY

We also look for other evidence of how a board is making decisions and interacting with management. One of the most transparent of these is its accounting policies.

Ultimately, the board is responsible for whether company accounts are prepared in accordance with AASB standards and provide a true and fair view of the entity's performance.

Therefore, questionable accounting practises raise questions about the judgement and oversight of the board, given accounts are being prepared by management.

"In our experience, governance problems often come down to judgement."

[1]Source: Ownerships Matters, Martin Currie Australia; as at 30 September 2018.

6. EXCESSIVE COMPENSATION, SHORT-TERMISM AND INAPPROPRIATELY ALIGNED INCENTIVE STRUCTURES

Remuneration is another vital area for judging how a board makes decisions and interacts with management. Management remuneration packages should be aligned to shareholders and the long-term interests of the company.

Excessive compensation that is poorly aligned with shareholder outcomes and encourages short-term or inappropriate behaviours is another red flag on governance. The poorer a board's quality, the more concerned we are with incentive structures that rely on subjective judgement by a board.

We prefer short-term incentives (STI) linked to short-term goals, and clawbacks for poor behaviours – even those which are uncovered down the track. We also like objective relative total shareholder return (TSR) hurdles in long-term incentives (LTI) to truly test whether board and management decisions are creating shareholder value.

We are very wary of boards that appear to view their job as just keeping the CEO happy by paying management as much as possible, à la 'happy CEO = a cruisy board job'.

We believe senior management compensation can be justified by

1. doing its job of running large complex organisations and implementing new initiatives to improve the organisation
2. protecting the long-term franchise of an organisation, including culture and relationship with customers and regulators
3. in doing this and making the right decisions, create value for shareholders.

Remuneration structures that produce large payments can only be justified by achievement of all three.

PROXY VOTING IS A POWERFUL TOOL

Annual General Meeting (AGM) season (typically October to December in Australia) is a critical time for investors to pass a message back to boards on their governance progress.

AGM resolution votes are all about governance, not about management – therefore a vote against the remuneration report is not necessarily a vote against the quality of the CEO.

For us, the poorer our view of a board's overall governance quality, the dimmer our view will be of each AGM resolution – be it director election, remuneration report or share grants – and we will actively vote proxies according to the outcomes of our governance framework.

[2]Source: Martin Currie Australia; as at 30 June 2018.

[3]Source: REP 564 Annual general meeting season 2017: Australian Securities and Investments Commission, published January 2018

[4]The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

WE ARE NOT AFRAID TO BE 'ACTIVE OWNERS'

In the 179 meetings for stock holdings in our portfolios over the past 12 months we have voted against more than 9% of resolutions[2].

This is significantly higher than the 5% average for ASX 200 company shareholders[3].

We have, however, found that many investors are not acting as active owners. This can partially be explained by the rise of passive investing and active managers who fully outsource proxy voting to third party advisors. Another concerning reason is investors who are conflicted by non-fiduciary thinking. For example, their judgement can be clouded by issues such as:

- avoiding damage to relationships with the company or directors sitting on boards of other investments;
- wanting to wait to engage before voting against; or
- concern that this could turn attention on themselves.

PUTTING IT INTO PRACTICE

In the 2018 AGM season to date, we voted against several key resolutions including[4]:

- Suncorp –
  - Re-election of Douglas McTaggart on poor track record (ex UGL chair of remuneration committee who awarded stock below market to new CEO and sold out to CIMIC at inappropriate price within divided board)
- Telstra –
  - Remuneration report on inappropriate structure (management compensation is not in line with pain felt by shareholders)
  - Re-election of Margaret Seale on over-boarding and poor track record (four other directorships at Scentre Group, Ramsay Health Care, Bank of Queensland, Australian Pacific Holdings)
- Tabcorp –
  - Remuneration report on inappropriate structure (STI should have been forfeited given losses from Sun Bets closure and subsequent losses)
  - Re-election of Steven Gregg on over-boarding, lack of industry experience, poor track record (director at time of anti-money laundering breaches and Sun Bets establishment)

Unfortunately, as described earlier, we are often the only shareholder consistently making these stands. In the case of **Suncorp**, we were the only investor to vote against the resolution.

FOCUS ON ACTIVE OWNERSHIP

Governance assessments are inherently difficult, but we see our framework for understanding good governance and assessing red flags as an important tool to cutting through the narrow collective thinking of boards and media reports.

Proxy voting at AGMs is a core element of our approach to active ownership. We believe it is our job as fiduciaries to make a stand where we see an issue as critical to a stock's performance in the long term.

We are concerned about the lack of analysis and engagement on governance that the rise of passive investing and proxy outsourcing brings. But, the current AGM season's remarkable protest proxy votes against director resolutions at large-cap Australian companies such as **Telstra** and **Tabcorp**[5] brings us some hope for active owners to enact positive change.

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Please refer to our recent article *Desperately Seeking: Board Accountability and Active Voices* for more of our thoughts on the recent AGM season.

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