For Professional Investors and Advisers Only

August 2016

Reforming Capitalism

RWC Equity Income

Investor letter Q3 2016

In our latest Investor Letter, Ian Lance examines the ideology of shareholder value maximisation and the extent to which it has distorted capitalism over the last thirty years.

Drawing on examples from the US, he looks at how different stakeholders in the economy have fared throughout this process.

In the second part, he puts forward seven reforms that should be considered in order to reform capitalism so that it works for everyone and not just the privileged few!



Portfolio Managers

Nick Purves and Ian Lance were previously responsible for Income based strategies at Schroders, co-managing approximately £5bn within the Income fund range since 2007. Nick and Ian joined RWC in August 2010 to establish the Equity Income franchise and were joined by John Teahan in September 2010. The reputation of the team precedes them; with over 60 years' investment experience, they are very highly rated amongst their peers. Nick, Ian and John co-managed the Schroder Income Maximiser, an income fund employing a covered call strategy. John also co-managed the Schroder Global Dividend Maximiser, Schroder European Dividend Maximiser and Schroder UK Income Defensive funds, all three of which employed a covered call strategy. Since joining RWC the team have fully integrated the process of call overwriting and the stock investment process, a fundamental, bottom up approach. The team has developed the strategy as a key part to delivering low volatility equity income.

Reforming Capitalism

The UK's new Prime Minister, Theresa May, has stated that she wants to 'reform capitalism so that it works for everyone, not just the privileged few'. As she set out the changes she wants made to the way that companies operate and how the interests of various stakeholders are aligned, she was clearly tapping in to a groundswell of discontent within the country that contributed to the surprise referendum result.

"What should be obvious, though, is that Mrs. May is onto something. The referendum vote was as much an expression of disenchantment with the elites and the workings of the liberal market economy as a repudiation of the works of Brussels. The same can be said of the rise of populist movements across Europe."[1]

Philip Stephens *Financial Times*

Huge numbers of people believe that the capitalist system as practiced in this country no longer works for them and are angry at the way big business has behaved for the past twenty years, in particular at perceived corporate excess. CEO pay has exploded with the average FTSE100 CEO making £4.7m p.a. or 183 times his average employee whilst the multiple is a staggering 373 times in the US.[2] For the average worker, however, real wages have not risen in the UK for ten years according to the Institute for Fiscal Studies.

Theresa May was speaking within a couple of weeks of Sir Philip Green being called in front of MPs to explain how he was able to hollow out BHS and leave its pension fund unable to meet its liabilities. The billionaire was accused by two Commons select committees of the "systematic plunder" of the high street chain and failing to address the deficit as he "accrued incredible wealth" for his family. MPs dubbed him 'the unacceptable face of capitalism'. During the same period, Mike Ashley, the founder and majority owner of Sports Direct, was also called in front of MPs to answer questions about his 'appalling' working practices which some had likened to that of Victorian mill owners. Unsurprisingly, trust in companies is at an all-time low according to the 2015 Edelman Trust Barometer Report.

How shareholder value maximisation distorted capitalism

Big business has not always viewed profit maximisation for the owners as their sole objective and this behaviour was not typical of managers just a few decades ago. In the fifties, Frank Abrams, Chairman of Standard Oil of New Jersey said: "The job of management is to maintain an equitable and working balance among the claims of the various directly interested groups … stockholders, employees, customers and the public at large." By paying good wages, investing in future products, and generating reasonable (not "maximized") profits, American companies in the 1950s and 1960s created value for all of their constituencies, not just one. During the same period, the country and economy boomed. Somehow over the last thirty years, however, this benevolent view of treating stakeholders equally was replaced by one in which management were expected to screw all other stakeholders in the name of 'shareholder value maximisation' (SVM).

The economic catalyst for SVM appears to have been the economic malaise of the seventies. In the bear market that followed, shareholders had to become more active in order to realise value from their equity investments. The intellectual support for this movement began with the Chicago School and specifically Milton Friedman who stated in a New York Times essay[3] in 1970: "There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits". Six years later, Harvard Business School economist Michael Jenson and University of Rochester business school dean William Meckling published an even more influential paper[4] in which they described shareholders as 'principals' who hire managers as their 'agents' and thus decided that managers should serve only shareholders' interests and not those of other stakeholders.[5] They also decided that shareholders' interests were purely financial and hence it was a manager's job to maximise the wealth of shareholders by doing everything in their power to increase the share price. From there it was only a small jump to decide that a manager's interest could be best aligned with shareholders by paying them in stock and options.

In the late seventies and early eighties, investors were given a stick with which to beat management who were not following SVM when a young financier called Michael Milken working at Drexel Burnham Lambert helped to develop the junk bond market. This new source of financing became an important weapon for the corporate raiders and leveraged-buy-out (LBO) firms that came to prominence in the 1980s. Drexel's ability to quickly raise hundreds of millions of dollars in "mezzanine" debt made the threat of buy-outs credible and forced many big companies to slim costs and increase returns to shareholders to stave off the threat of takeover.

The way in which SVM influenced corporate behaviour throughout this period can be observed by looking at how IBM's mission statement changed over time.[6] In the 1970s, when it was run by Tony Watson, the son of the founder, the guiding principles of the business were: i) respect for individual employees, ii) a commitment to customer service, and iii) achieving excellence. The shareholder was not even mentioned. This changed slightly in the 1990s when the CEO Lou Gerstner described the company's objective as "Our primary measures of success are customer satisfaction and shareholder value," but by 2010 any mention of the customer or employee had gone and Sam Palmisano's primary aim was to "double earnings per share over the next five years."

1 "May is right about reforming capitalism," Philip Stephens, Financial Times, 28 July 2016

2 "How Good We Can Be: Ending the Mercenary Society and Building a Great Country," Will Hutton, 2015. The UK figure is higher than the US when adjusted for the size of the company they manage

3 Milton Friedman "The Social Responsibility of Business is to Increase its Profits" New York Times Magazine September 13 1970

4 Michael Jensen and William Meckling "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" Journal of Financial Economics October 1976

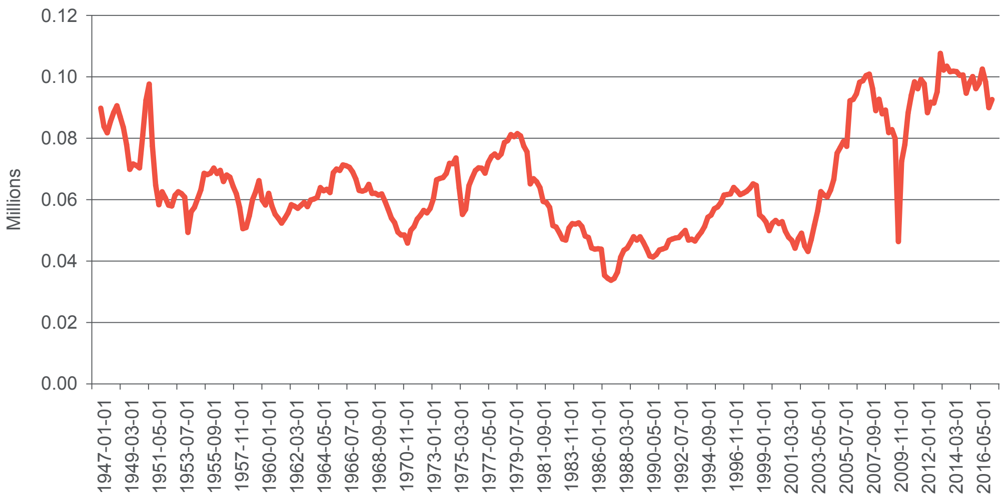
5 They were wrong in this assertion – See Appendix 'Three myths about shareholder primacy'

The negative impact of SVM on the wider economy

The impact of the widespread adoption of these practices by corporate America on the economic and social fabric of the country can be clearly seen in the charts on the following pages, and whilst it is impossible to claim that SVM was completely responsible for this, it seems likely it played a major part.

Firstly, corporate profits soared to all-time highs in the US during the period 1980 to the present date as can clearly be seen in figure 1.

FIGURE 1:
CORPORATE PROFIT AFTER TAX/GROSS DOMESTIC PROFIT

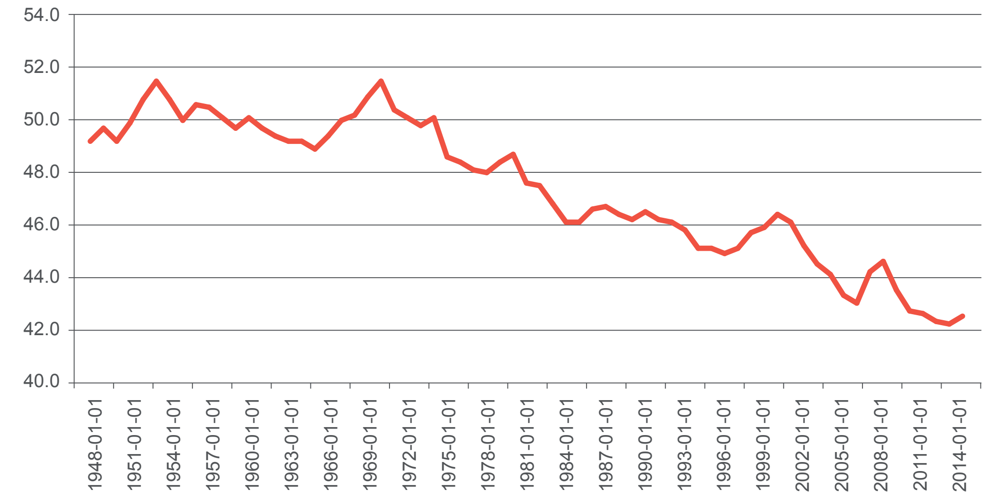


Source: US. Bureau of Economic Analysis, FRED, 01/01/47 to 01/01/16, as at 29/07/16

However this increase in profitability has come at a cost, such as the practice of paying employees as little as possible, reducing the numbers of employees (offshoring jobs) and hence compensation as a percentage of GDP has fallen to a low point. It is not hard to work out why the average employee might feel more than a little resentment.

6 The World's Dumbest Idea by James Montier GMO

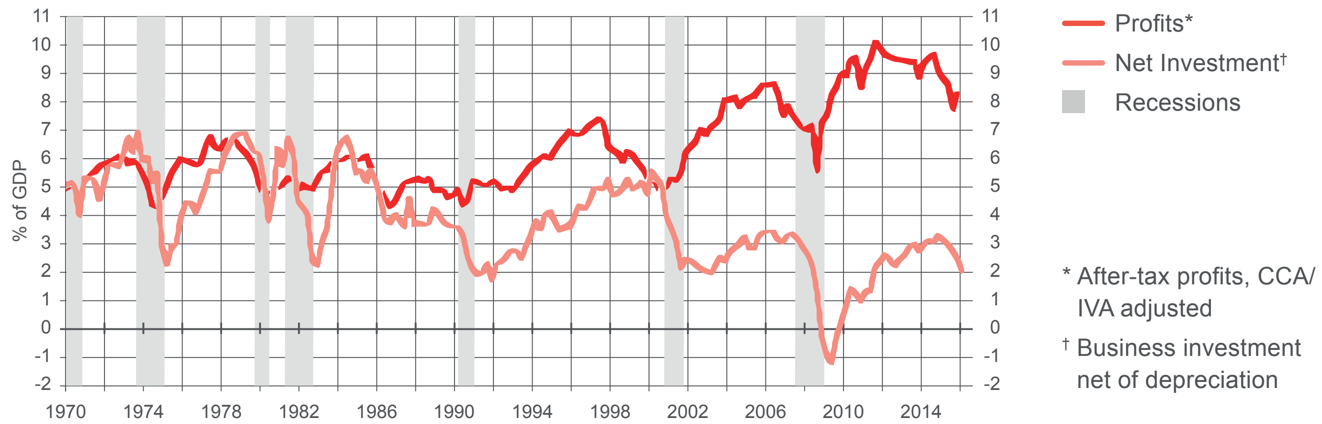
FIGURE 2:
COMPENSATION OF EMPLOYEES AS PERCENTAGE OF GDP



Source: US. Bureau of Economic Analysis, FRED, 01/01/48 to 01/01/14, as at 29/07/16

Executives also boosted profitability by cutting back on investment as shown in figure 3.

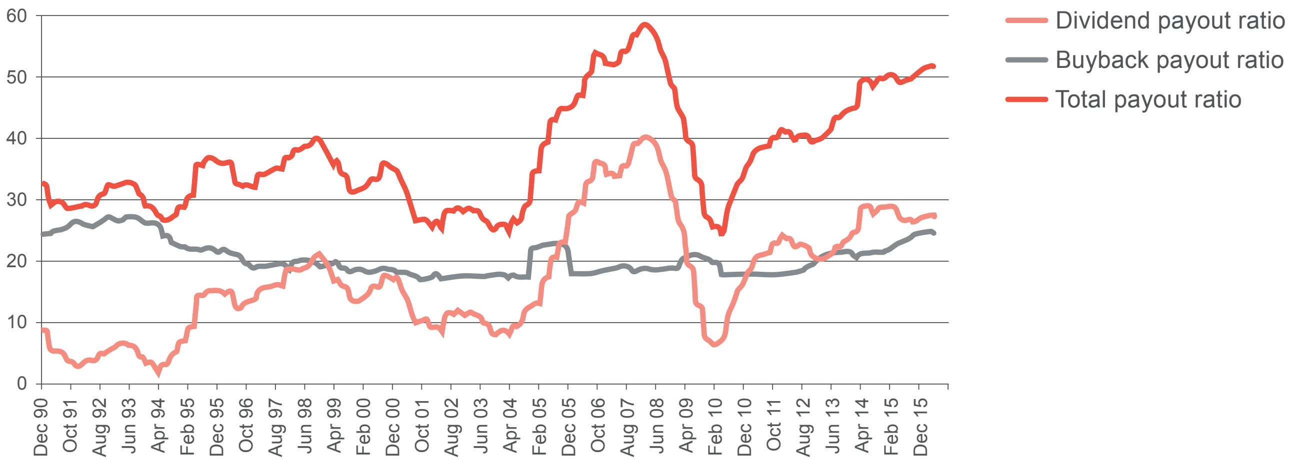
FIGURE 3:
TOTAL BUSINESS INVESTMENT AS A % OF GDP



Source: BEA, BLS, NBER, 1970-2015

So rather than hire or invest, the new focus on shareholder value maximisation saw an increase in returning cash via share buybacks, as this was one of the easiest ways to move share prices higher in the short term even if it had little benefit in the long term.

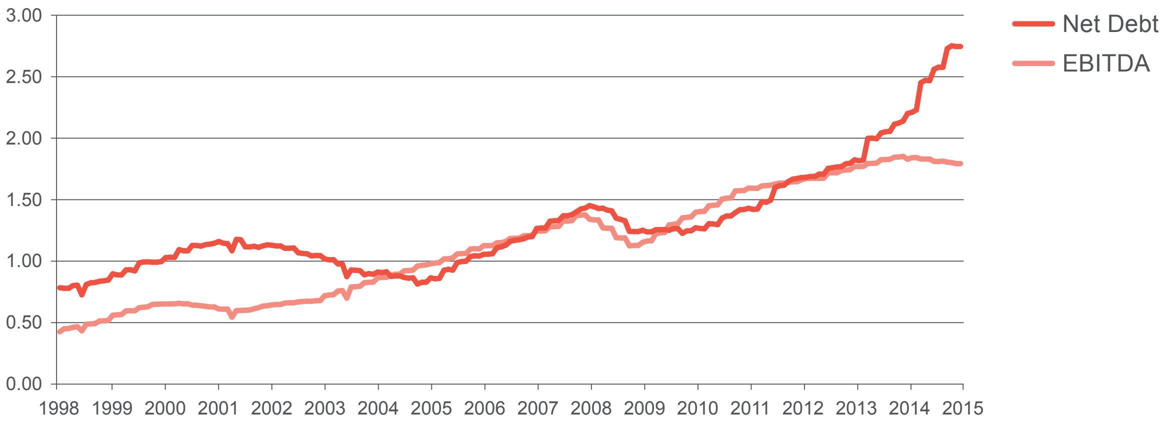
FIGURE 4:
DIVIDEND AND BUYBACKS AS A % OF GROSS CASH FLOW



Source: SG Cross Asset Research, 31 Dec 90 to 31 Dec 15, as at 31 Dec 15

Much of the money returned to shareholders was funded by leveraging up the company with debt in order to buy back shares, which has the downside of making both the company and the economy more fragile in the long run.

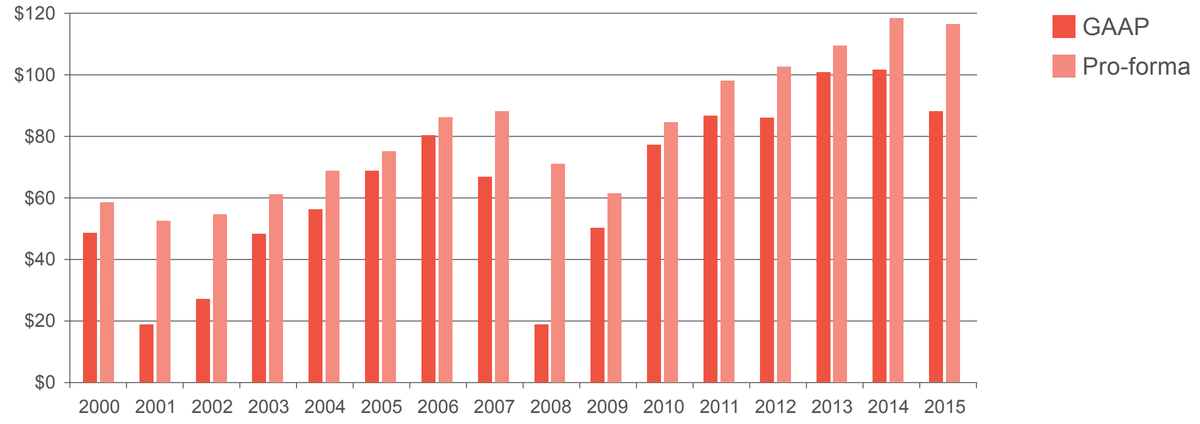
FIGURE 5:
S&P 1500 NET DEBT TO EBITDA RATIO



Source: Société Générale, 31 Dec 98 to 31 Dec 15, as at 31 Dec 15

Other nefarious practices were used to inflate short term profits such as tax avoidance; companies such as Google, Apple, Amazon and Starbucks moved the source of their profits around the world to the country with the lowest tax rate and hence cheated governments out of corporate tax revenue. In some cases, such is the desire to inflate profits that misleading accounting practices were used, sometimes in extreme ways such as Enron and Worldcom and more commonly through getting investors to focus on 'adjusted earnings,' which were usually higher than 'GAAP earnings'.

FIGURE 6:
THE GAAP GAP – S&P 500

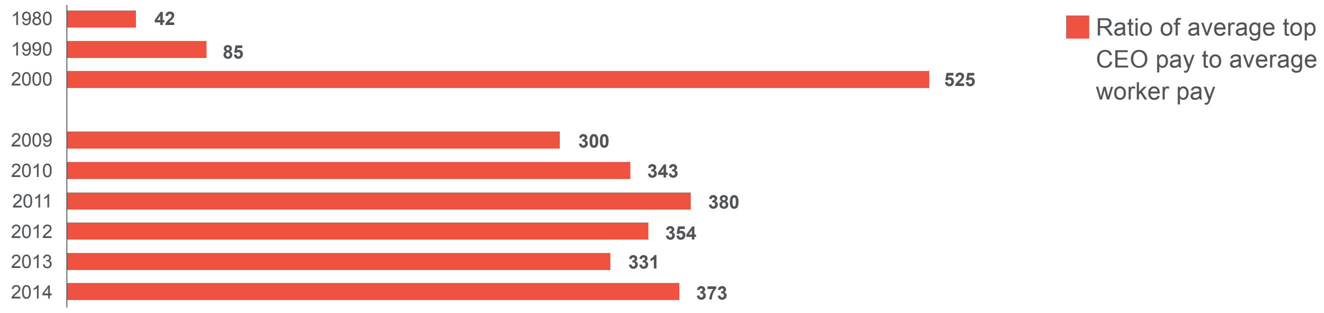


Source: Bloomberg, 31 Dec 99 to 31 Dec 15, as at 31 Dec 15

Trust in companies has also been harmed by a constant stream of scandals by companies including in recent years Tesco, BP, Volkswagen, Valeant, Petrobras and by the never ending stream of abuse carried out by the banks (Libor rigging, PPI mis-selling, money laundering, mis-selling interest rate swaps, rigging of foreign exchange markets).

This process has, however, been fantastic for those at the centre of it, namely company executives who have seen their pay soar.

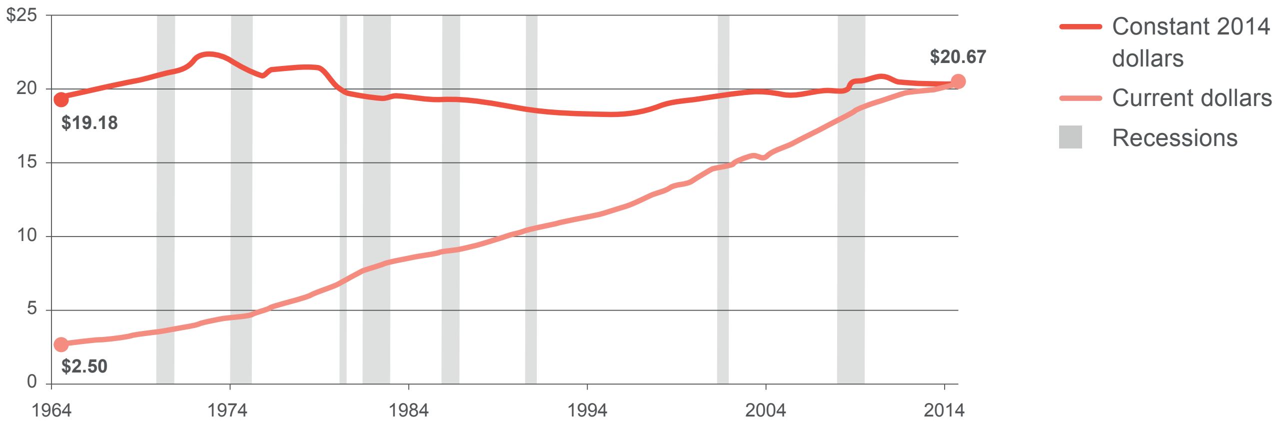
FIGURE 7:
TOP CEOs VS AVERAGE WORKERS: S&P 500 CEOs EARNED $13.5M IN 2014, 373 TIMES THE AVERAGE US WORKER



Source: The Wall Street Journal, 13 May 2015

Conversely, the average worker has seen no real growth in wages since 1964.

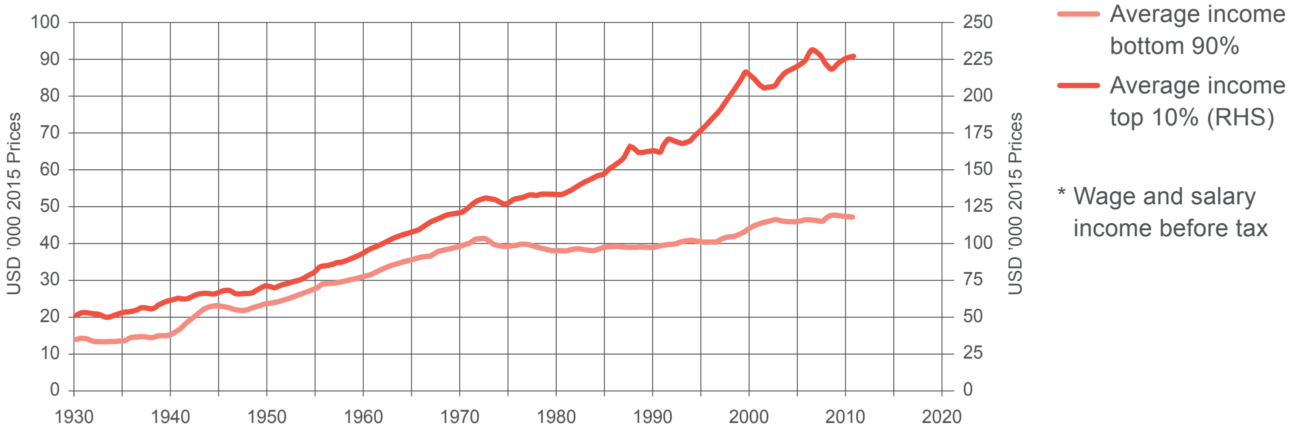
FIGURE 8:
AVERAGE HOURLY WAGES, SEASONALLY ADJUSTED



Source: Pew Research Center, 9 October 2014.
Note: Data for production and non-supervisory employees on private non-farm payrolls.

The combination of these trends has contributed to the increase in inequality in the US and elsewhere that has further spread resentment on the part of those who did not enjoy the gains.

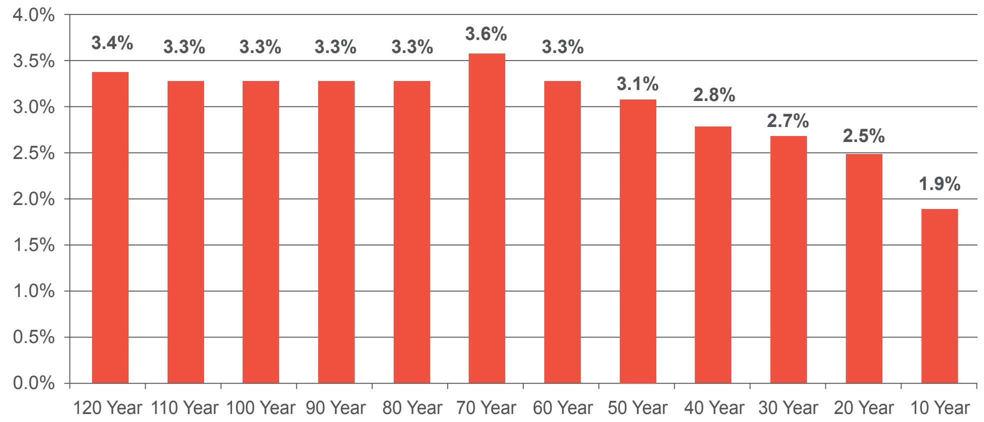
FIGURE 9:
THE DISTRIBUTION OF LABOUR INCOME: REAL US INCOME



Source: Minack Advisors, 21 July 2016

Unsurprisingly these policies have been negative for the economy. It didn't seem to occur to anyone that one company's employees are another company's customers or that one company's investment is another's order book and that continually cutting back on these costs might have a detrimental impact on overall economic growth.

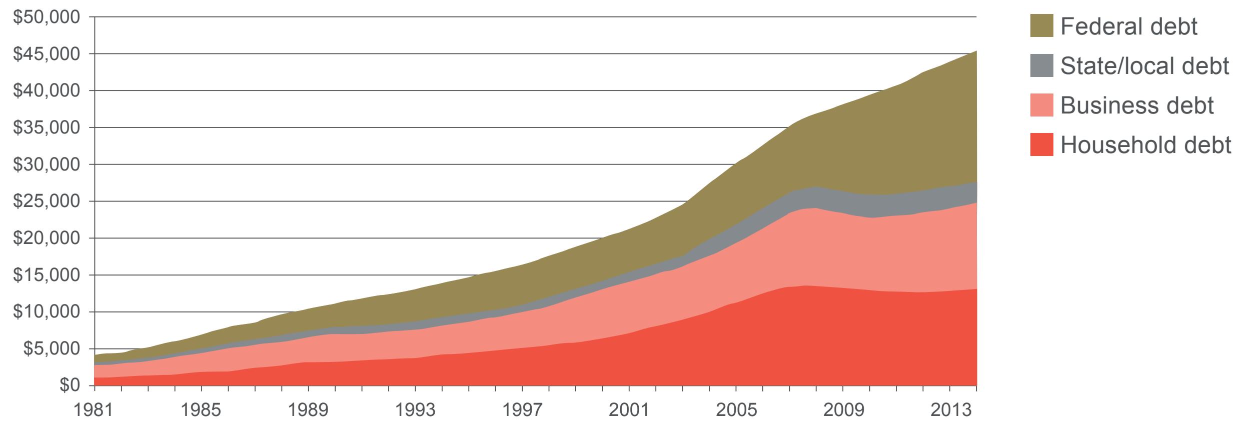
FIGURE 10:
US ANNUAL AVERAGE GDP GROWTH, YEARS TO 2009



Source: Calculated 1889-1929 from the Economist 100 Years of Economic Statistics, 1929-2009, Bureau of Economic Analysis NIPA Table 1.1.3.

Faced with stagnant real wages, consumers turned to debt in order to maintain their desired level of consumption and politicians did the same in order to fund the level of spending necessary to get them re-elected.

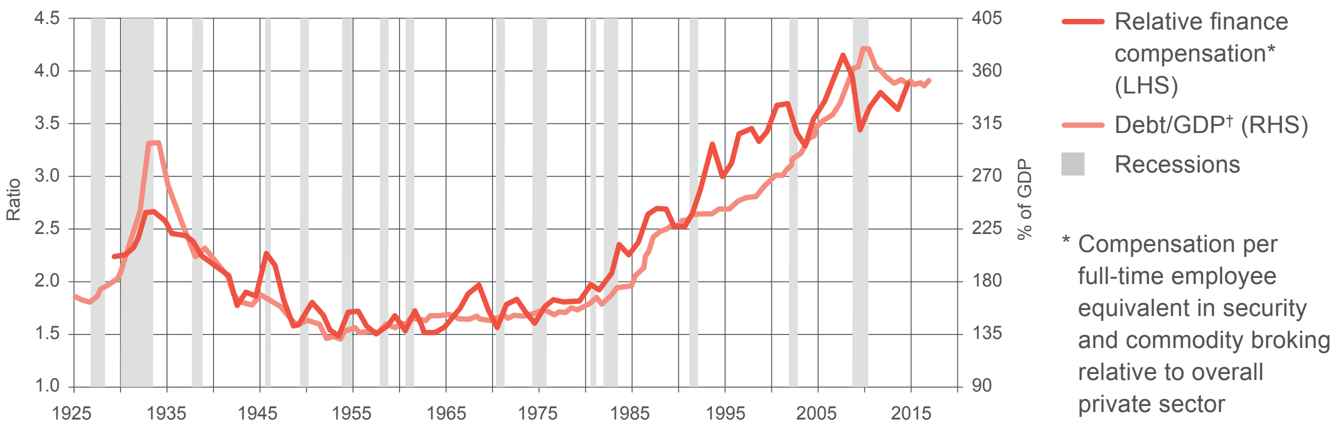
FIGURE 11:
TOTAL OUTSTANDING DEBT IN US: 1981-2014, $BN



Source: My Budget 360, 4 Feb 2016

And finally this huge growth in debt was good for the profitability of one group; the financial services industry and for the compensation of bankers.

FIGURE 12:
US RELATIVE PAY IN FINANCE AND ECONOMY-WIDE LEVERAGE



* Compensation per full-time employee equivalent in security and commodity broking relative to overall private sector

† Total debt (private & public) to GDP

Source: Minack Advisors, 21 July 2016

Improving the system

Given that this system has clearly favoured the few whilst failing the many it feels unsustainable, but improving it will not be easy since there is a long list of very influential people who have benefitted enormously from it and will fight tooth and nail to preserve it; corporate managers, non-executives, shareholders (fund managers), investment banks, politicians and other miscellaneous advisors have all seen their wealth rise dramatically in the last two decades. These participants are unlikely to reform themselves and hence it seems likely that a carrot and stick approach will be required in which both incentives and regulation bring about change in corporate behaviour.

What seems unlikely to work?

Let's start with what is not the answer. I don't think more committees, working groups and reports are going to change anything since the vested interests seem predisposed to ignore anything that is advisory in nature. The Kay Review of UK Equity Markets and Long Term Decision Making was wide ranging and excellent but appears to have changed very little since its publication in 2012. Sitting at my desk during the quarterly results season and watching company after company engineer a pop in their share price as they beat analysts' forecasts (which they themselves had guided down in the weeks before), whilst simultaneously giving guidance on future cost savings (redundancies) and share buybacks, it is hard to believe that most companies are focused on anything other than the short term. In addition, issuing guidelines that encourage shareholders to act more responsibly is unlikely to work in a globalised world where 40% of British shares are held overseas and British pension funds own a mere 5% of all shares and British insurance companies 8.6% (the total of the two was 50% in 1991).[7]

7 How Good We Can Be: Ending the Mercenary Society and Building a Great Country," Will Hutton, 2015

So what could be done? Seven reforms that should be considered

1. Redrafting the Companies Act

The interesting fact is that the basic framework for improved corporate behaviour is already in place, but it is too general and hence allows companies to subvert the spirit of the law. Under Section 172 of the Companies Act 2006, directors must act in a way that they would consider to promote a company's success but must have regards to a non-exhaustive list of factors including the interests of employees, the company's relationship with suppliers, customers and others, the company's impact on the community and the environment, and the desirability of maintaining a reputation for high standards of business conduct. In his book 'How Good We Can Be' Will Hutton argues that the Companies Act is too vague and needs tightening up.

"The cornerstone of a new approach to ownership should be a Companies Act for the 21st century. Unlike the existing act, passed in 2006, this would set out unambiguously what society expects from companies in exchange for the privileges they are afforded.

"The objective is to put business purpose at the heart of every enterprise and make it something for which directors are held to account – to create a societal obligation to match the privileges of incorporation. This will not be a weaselly commitment to "have regard to" the delivery of business purpose, echoing section 172 of the current Companies Act. It should be a statutory obligation. Directors will have to produce an annual account of their stewardship of the company, of which today's financial reporting will be but one element."[8]

2. Improving the professionalism of non-executives and hence the effectiveness of non-executive boards

"And I want to see changes in the way that big business is governed. The people who run big businesses are supposed to be accountable to outsiders, to non-executive directors, who are supposed to ask the difficult questions, think about the long-term and defend the interests of shareholders. In practice, they are drawn from the same, narrow social and professional circles as the executive team and – as we have seen time and time again – the scrutiny they provide is just not good enough."

Theresa May speech in Birmingham on 11 July 2016

In our previous investor letter 'Just Say No' we highlighted how the board of Royal Bank of Scotland, which required a U.K. government bailout in 2008, was accused of failing to stand up to illustrious CEO Fred Goodwin on his ambitious expansion strategy.

"A deal that ended up with British taxpayers lending RBS £45bn went through because the great and the good on the board were unwilling to speak up."[9]

When talking about the financial crisis in 2009, Larry Fink of Blackrock said: "I don't think risk management failed, I think corporate governance failed because the boards didn't ask the right question". To that end, the non-executives should be experienced and powerful enough to stand up to a strong CEO, and for this situation to improve, board members may have to devote more time to their roles. McKinsey have noted that that this type of failure is rarer with family owned companies and have suggested public companies should behave more like private ones, i.e. in the absence of a dominant shareholder, the board must represent the firm's owners and serve as an agent of long-term value creation.

If a non-exec has shown him or herself to be utterly toothless and/or incompetent, then surely they should be prevented from taking further non-executive roles? The British public should be rightly outraged that the NEDs of RBS who nearly blew up the country (and many of whom were Knights of the Realm) should just move on to the next highly paid job but this is exactly what happened. It cannot be right that a doctor who makes a mistake can be struck off but a non-executive who plays a part in nearly bringing down the UK economy moves swiftly on to his next job. Conversely a NED who continually asks difficult questions is unlikely to get a job at another company and hence shareholders should take a greater interest in the appointment of these people who ultimately should represent their interests. If shareholders are not willing to prevent this sort of abuse then perhaps there should be a professional non-executive body responsible for quality control of their members.

8 Will Hutton 'How good we can be: Ending the mercenary society and building a great country'

9 RWC Income Q2 2016 Investor Letter

3. Employee Directors

A more radical idea, and one that Theresa May has mooted, is to put other stakeholders (such as employees and consumers) onto the board which is a practice more commonly adopted in Northern Europe.

"So if I'm Prime Minister, we're going to change that system – and we're going to have not just consumers represented on company boards, but employees as well."

Theresa May speech in Birmingham on 11 July 2016

This corporate model of having employee directors is one more typically associated with countries such as Germany, Japan, Sweden, Denmark and Austria, or what Professors Hall and Soskice named 'coordinated market economies' in their 2001 book 'Varieties of Capitalism'. The authors drew the distinction between coordinated market economies (CMEs) and liberal market economies (LME) such as US, UK, Canada, Australia, New Zealand, Ireland and suggested these differing capitalist models deliver different kinds of firm behaviour and investment patterns. Hence, in the LMEs, fluid labour markets fit well with easy access to stock market capital and the profit imperative, making LME firms the "radical innovators" they have proven to be in recent years, in sectors ranging from bio-technology through semi-conductors, software, and advertising to corporate finance. In the CMEs, by contrast, long-term employment strategies, rule-bound behaviour and durable ties between firms and banks underpinning patient capital provision predispose firms to be "incremental innovators" in capital goods industries, machine tools and equipment of all kinds. For those people who feel that the liberal market capitalism model has failed them, the type of corporate governance practiced in countries like Denmark with its employee representatives, flat structures, heavy investment in staff and long term planning is likely to appeal. Although Soskice has cautioned that it is difficult to cherry pick the best parts of this system without importing the entire infrastructure, I certainly feel it a change worth exploring.

Predictably, no sooner did Theresa May propose employee directors than howls of indignation went up from some parts of the fund management community[10] on the grounds it would 'damage our best boardrooms' I wholeheartedly disagree with this premise. Firstly, the idea that most UK companies do not have at least two employees who could make a positive impact at the boardroom is frankly insulting, particularly in light of the poor performance of so many non-executives. Secondly, if the board is so dysfunctional that it could be thrown off course by the addition of two employees, then it suggests to me that the board is wrong.

4. Reforming CEO pay

Corporate pay is on the agenda partly because the public perceive it to be excessive and unwarranted in many cases and it would appear that these concerns are accurate. A working group headed by Nigel Wilson, the CEO of Legal and General, has recently reported on this issue of Executive Remuneration. Their interim report described the current approach to executive pay as "not fit for purpose … resulting in a poor alignment of interests between executives, shareholders and the company … which has resulted in widespread skepticism and loss of public confidence" but also the fact that it is not tied in to the performance of the company.[11] The high rewards many executives are receiving currently have little to do with their impact on their business and instead are courtesy of central bank obsession with levitating asset prices. In addition, few compensation schemes carry consequences for failure which became very clear during the financial crisis.

Again this is an area that Theresa May highlighted as high on her agenda, in particular making votes on pay binding.

10 'Sorry Mrs May but employee-directors could damage our best boardrooms'

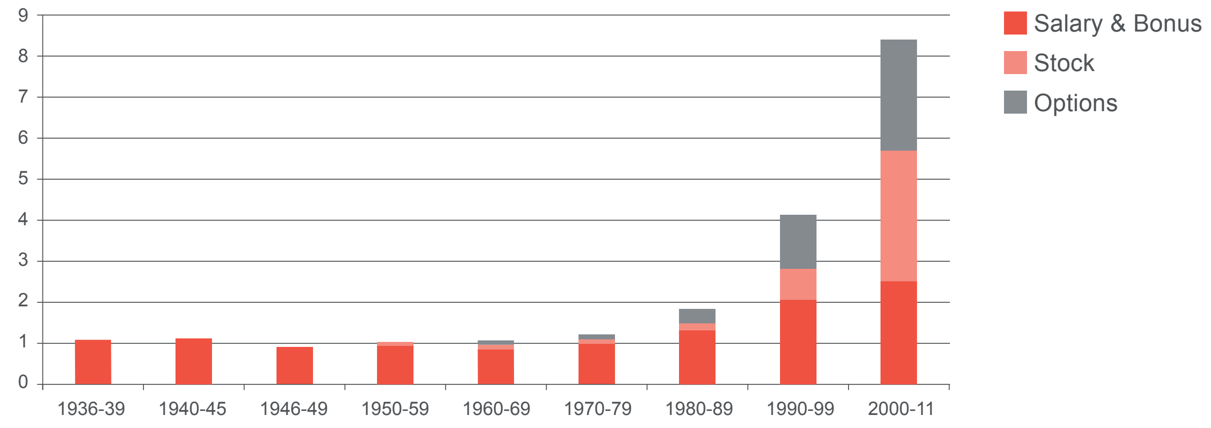
11 Executive Remuneration Working Group, Interim Report, April 2016. Unfortunately the proposals in the recently published final report are very disappointing and unlikely to promote change

"So as part of the changes I want to make to corporate governance, I want to make shareholder votes on corporate pay not just advisory but binding. I want to see more transparency, including the full disclosure of bonus targets and the publication of "pay multiple" data: that is, the ratio between the CEO's pay and the average company worker's pay. And I want to simplify the way bonuses are paid so that the bosses' incentives are better aligned with the long-term interests of the company and its shareholders."

Theresa May speech in Birmingham on 11 July 2016

A second point to grasp here, however, is that pay needs to be reformed not just from some moral point of view but also because management remuneration is responsible for many of the difficulties the economy faces today such as lack of investment and excessive debt levels. As Andrew Smithers argues convincingly in his book 'The Road to Recovery'[12] the most likely explanation for the change in corporate behaviour over the last twenty years is the change in compensation; although total pay has shot up, much of it is now paid as a bonus often as share options.

FIGURE 13:
MEDIAN CEP PAY ($M, CONSTANT 2011 $)



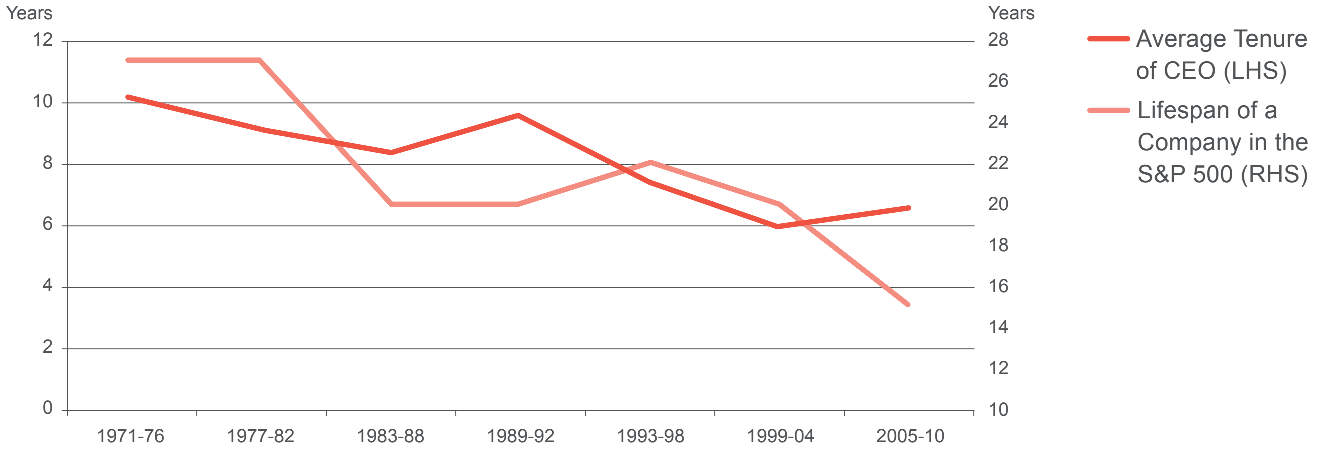
Source: Frydman and Jenter, Murphy, September 2014

12 "The Road to Recovery: How and Why Economic Policy Must Change," Andrew Smithers, 2013

The average length of time that a manager holds onto his job has declined dramatically. In the 1970s, the average CEO held his position for almost 12 years. More recently this has almost halved to an average tenure of just six years. Thus executives have the opportunity to make a large amount of money but a short time period in which to do it and this naturally alters their attitude towards things like long term capital projects which can depress short term earnings but increase long run returns. Faced with this choice, managements have a much greater incentive to prefer share buybacks over investing.

So any reform in compensation needs to change this incentive structure in order to change corporate behaviour. My own belief is that compensation must be tied to long term drivers such as innovation and efficiency not just the share price. The time frame for executive evaluations should be extended. There should be a downside risk by requiring them to have some skin in the game. Boards need to be incentivised to think and act long term so that CEOs should run the company with the next quarter of a century not just the next quarter in mind. This appears to be one of the greatest differences between the Asian and the Western corporate world where the former will usually invest with a ten year horizon whilst the latter may not consider an investment that may make them miss their quarterly earnings. As McKinsey have pointed out, if 70-90% of a firm's value is in the period beyond three years, it makes no sense for CEOs to focus so much on the short term. In order for them to do this, however, shareholders must give them time for their strategy to work – firing someone after twelve months because earnings are not instantly improving is wrong headed.

FIGURE 14:
AVERAGE TENURE OF A CEO



Source: Conference Board, Foster, September 2014. Universe based upon companies within the S&P 500 Index

5. End the tax deductibility of debt and increase the financial incentive for investment and hiring

This strikes me as one of the most straight forward changes to make and one which we have proposed previously. Currently companies are given a financial incentive to favour debt over equity as the former is tax deductible. This incentive structure should be changed and yet it does come with a risk. If these changes are only implemented in the UK, then firms will potentially become prey to overseas corporate raiders who finance their deals with large amounts of tax deductible debt. This may warrant a reform of the Takeover Code given that £440bn worth of British companies have been sold to overseas interests in the last ten years and again, this was an area hinted at by Theresa May in her Birmingham speech.

6. End quarterly reporting

This role cannot be left to the private banks who now see their main function as assisting in property speculation which they think is very low risk as it is secured on an asset whose price never seems to do anything but go up. Of the £1600bn of bank lending in the UK in 2012, less than 14% went to business investment in non-real estate whilst 14% went to commercial real estate, 65% residential mortgages, and 7% consumer credit. This is dramatically different from history; as recently as 1970 real estate lending was less than 35% of the total.[13] Unfortunately creating credit that just pushes up the prices of existing assets is of little benefit to the wider economy and hence this would appear to be another area to which the government could lend support by creating a body that funds innovative start-ups and small businesses.

If executives are going to think and act long term, they should stop giving quarterly guidance to the market which again only seems to benefit short term traders. Firms like Unilever, Coca Cola and Ford have already stopped giving earnings guidance and we would encourage others to follow their lead.

The Financial Conduct Authority has scrapped the rule requiring public firms to release interim management statements, as part of the government's push to encourage more long-term thinking in the stock markets. We would encourage more firms to make this transition as we believe quarterly reporting tempts companies to cut costs like Research and Development or Advertising and Promotion in order to make the numbers but this then damages the company in the long term. We would far rather companies give five to ten year road maps and update people on progress using metrics that are appropriate like ten year EVA, R&D efficiency, multiyear return on capital investments.

13 Adair Turner Between Debt and the Devil

7. Reforming Fund Management/Encouraging more responsible ownership

"Short-termism is a disease that infects American business and distorts management and boardroom judgment. But it does not originate in the boardroom. [It] is bred in the trading rooms of the hedge funds and professional institutional investment managers who control more than 75% of the shares of most major corporations."[14]

Under pressure from their investors, many large fund managers created Environmental, Social and Governance (ESG) departments who were tasked with monitoring and engaging with companies the firm invested in and creating reports to clients. Despite all this, corporate behaviour seems to have become worse not better as highlighted above. In short, ESG policy seems to have become a bureaucratic nightmare for companies and investors alike with very little benefit to show for it. Drawing on comments made by asset managers at a recent conference, Pauline Skypala, FTfm editor, wrote: "It is not at all clear that greater engagement by fund managers will lead to better governed companies. There is no evidence that this is the case."[15]

Reforming the approach of asset managers is by its nature very difficult because they are such a disparate group. One will frequently see statements such as: "shareholders should be more long term or be more responsible". These statements assume that 'shareholders' are one amorphous mass with shared incentives and objectives but unfortunately that is not the case. Even if we think a share buyback or acquisition is unwise, frequently other shareholders will disagree with us and therefore may want to push ahead (remember professional fund managers voted through the disastrous RBS acquisition of ABN AMRO). This has become increasingly important in the last few years where activists take a small stake in a company and then bully management into policies that suit them but hurt other shareholders and potentially the economy. This is another area where a strong board is critical as it should act as a counter balance to the divergent wishes of disparate groups of shareholders.

With this in mind, we think the government should consider the following:

- Owners of capital must demand more from their agents (fund managers)

  As the title of John Kay's book implies, the fund management industry looks after 'Other People's Money'[16] and in many cases those other people are the ones who are losing out from the current structure of the capitalist system. It seems perverse in the extreme that collectively fund managers take other people's money and then pressurise corporate boards to behave in a way that is against the interests of those very same people. The people who allocate this money must, however, share in the blame for this as they focus too heavily on short term returns and will quickly fire a manager who lags behind a cap weighted benchmark. This naturally alters the behaviour of fund managers who become momentum chasing speculators rather than long term investors. The providers of this capital must, therefore make a choice. Do they want their manager to maximise short term returns or behave in a manner than is more beneficial to society as a whole but which may take longer to produce a return. As pools of capital start to come together, particularly those drawn from the public sector, it seems only right that they should become more demanding of their asset manager in this respect.

  Many of the longer term focused countries such as Norway and Singapore have developed their own sovereign wealth funds. Whereas the UK blew the dowry from the North Sea oil, the Norwegians were far-sighted enough to invest it for the long term benefit of the people and now have an $800bn fund. In addition, however, they now also have a large and responsible shareholder who is actively engaged with the companies in which it invests. In the absence of a UK sovereign wealth fund, this is potentially a role that the consolidated local authority pension funds could play.

- Changes to voting structures

  72% of stock market trading is now done by hedge funds, high frequency traders or investment banks trading their own accounts. Arguably shares should attract more votes the longer they are held. It has never seemed right that a share held by the descendants of the company's founder should attract the same level of votes as a startup hedge fund looking to carry out the corporate equivalent of a drive by shooting. In mainland Europe, this dual voting structure is much more common with, for example, the Wallenberg family in Sweden owning 19% of SAAB by value but having 38% of the votes. In return, however, the Wallenbergs are very long term shareholders and very engaged investors who will frequently have a seat on the board of companies they invest in.

- Encourage employee ownership

  If employees amassed a share in the business and they used their collective power, they might be able to act as a counter weight to unscrupulous management and short term speculators.

Conclusion

"Because the free market system is so weak politically, the forms of capitalism that are experienced in many countries are very far from the ideal. They are a corrupted version, in which powerful interests prevent competition from playing its natural, healthy role."

Raghuram G. Rajan, *Saving Capitalism from the Capitalists*[17]

I remain a believer in free market capitalism which has lifted more people out of poverty than any other system. I also have no problem with wealth where it is justified – if you develop an engine that runs on grass cuttings and has no emissions, you deserve to make a lot of money from it. Finally, I am also deeply opposed to creeping government interference and heavy handed regulation as I believe this is one of many factors that has hampered our economy in recent years.

I am, however, forced to admit that as Raghuram Rajan implies, our model of capitalism is not ideal – we are running a crony capitalist system that favours the few and hence urgently needs reforming. I am not, it would seem, the only person that realises that if capitalism doesn't reform itself, the alternative may be much worse. McKinsey managing director Dominic Barton, explained from his meetings with over 400 business and government leaders worldwide that:

"… there is growing concern that if the fundamental issues revealed in the crisis remain unaddressed and the system fails again, the social contract between the capitalist system and the citizenry may truly rupture, with unpredictable but severely damaging results."

The 'greed is good' era that was typified by shareholder value maximisation feels like it is reaching its denouement. In the future companies will be under increasing pressure to act in the interests of all stakeholders and whilst this is likely to face opposition, it is wrong to think of this as anti-business. There never was really any inherent tension between creating value and serving the interests of employees, suppliers and customers. As Will Hutton states:

"To argue for the reform of capitalist enterprise should not be interpreted as "anti-business"; rather it is to be anti-dysfunctional business. For at their best, companies are organisations of genius, solving problems, innovating and delivering great goods and services. They should not be allowed to degrade into instruments of stock market speculation, so that managers are governed by the new god – the share price – and the temptations of their own colossal self-enrichment. Yet that is what has happened for a generation."[18]

14 M. Lipton, T. Mirvis & J. Lorsch, "The Proposed "Shareholder Bill of Rights Act of 2009" Harvard Law School Forum on Corporate Governance & Financial Regulation (May 12, 2009)

15 "Let's be realistic about engagement", Financial Times, 20 May 2012

16 "Other People's Money: Masters of the Universe or Servants of the People?," John Kay, 2015

17 "Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity," Raghuram G. Rajan, Luigi Zingales, 2013

18 "How Good Can We Be: Ending the Mercenary Society and Building a Great Country," Will Hutton, 2015

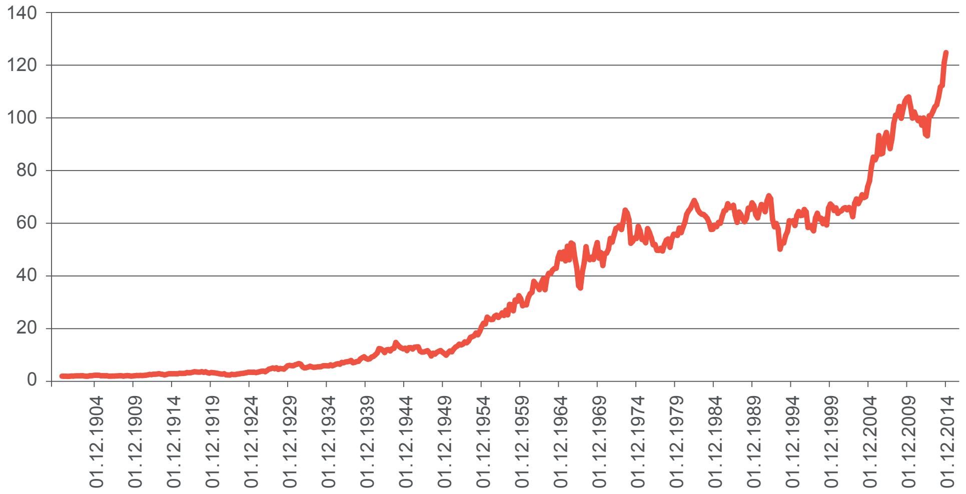
Theresa May's initial speeches suggest she has understood the need to reform capitalism in the UK, but it will be her actions in the following months and years that demonstrate how determined she was to make the necessary changes.

Even without changes to legislation, shareholders must come to realise that for them to thrive does not require other stakeholders to suffer, all stakeholders can prosper at the same time and some very successful companies demonstrate this fact. Johnson and Johnson established their credo in 1943 and are still using it today:

"We believe our first responsibility is to the doctors, nurses and patients, to mothers and fathers and all others who use our products. … We are responsible for our employees. … We are responsible the communities in which we live and work and to the world community as well … our final responsibility is to our stockholders."

Looking at the returns that those stakeholders have enjoyed, I don't think they would begrudge this commitment to other sections of society and see no reason why this type of model shouldn't be more widespread.

FIGURE 15:
JOHNSON AND JOHNSON SHARE PRICE



Source: Bloomberg, 31 Jan 77 to 02 Aug 16, as at 02 Aug 16

Appendix – Three myths about shareholders primacy

I frequently hear fund managers state words to the effect of 'we own the company and we appoint executives to run it in our interests'. Given the short term time frame of most fund managers, this usually translates to 'get the share price up as quickly as possible using any means practicable'

There is just one flaw in the argument – shareholders don't own the company (the following is taken from 'The Shareholder Value Myth' by Lynn Stout).

Myth 1. Shareholders own corporations

Corporations are independent legal entities that own themselves. A shareholder owns shares of a stock which is simply a contract between the shareholder and the corporation which gives the shareholder rights under limited circumstances. In this sense, stockholders are no different from bondholders, suppliers and employees. All have contractual relationships with the corporate entity but none 'owns' the company itself.

Myth 2. Shareholders are the residual claimants

A second myth is that shareholders are 'residual claimants' i.e. that after the company has met all its basic obligations such as wages, interest and taxes, shareholders are entitled to all residual profits. This idea has its roots in the bankruptcy law where courts distributing the assets of a liquidated company are deemed to pay stockholders last. This does not, however, apply to a going concern. Shareholders are only one of several groups that – at the board of directors discretion – are residual claimants and risk bearers in corporations, in the sense that they gain or lose as the company's health fluctuates.

Myth 3. Shareholders are principals and directors are their agents

In law a principal normally refers to someone who hires another person (his 'agent') and thus the principal must exist prior to and be independent of the agent. When someone incorporates a company, however, the first thing he does is to appoint a board who then have the ability to issue stock and contract with stockholders. In which case, the stockholders cannot be principals in the eye of the law since they did not exist prior to the appointment of the board. Finally, a principal is said to be able to control an agent's behaviour and yet one of the most fundamental rules of corporate law is that corporations are controlled by directors not shareholders. The latter merely have the right to vote, the right to sue and the right to sell their shares.

This is a very important point. As Stout states in her book: "shareholder value ideology is just that – an ideology, not a legal requirement or a practical necessity of modern business life. United States corporate law does not, and never has, required the directors of public corporations to maximise share price or shareholder wealth. … Chasing shareholder value is a managerial choice, not a legal requirement."[19]

19 "The Shareholder Value Myth," Lynn Stout, 2012

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As an organisation we aim to be both sustainable and long-term in our decision-making. We understand that our future is defined by the ongoing ability to meet our clients' long-term objectives.We have a strong ownership structure that supports these beliefs and encourages stability, flexibility, and the highest governance standards.

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About the team

Nick Purves
Nick joined RWC in August 2010. He was previously senior portfolio manager at Schroders for over 16 years managing both Institutional Specialist Value Funds and the Schroder Income Fund and Income Maximiser Fund together with Ian Lance. During his time at Schroders, Nick was Citywire AAA, Nick and Ian's Income fund was Morningstar 5 star rated, AA rated by OBSR and won the Moneywise award in 2009 in the UK Equity Income and Equity Income and Growth sectors. Nick is a qualified Chartered Accountant.

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John Teahan
John joined RWC and the Equity Income Team in September 2010. He previously worked at Schroders, where he co-managed the Schroder Income Maximiser with Nick Purves and Ian Lance. John also co-managed the Schroder Global Dividend Maximiser, Schroder European Dividend Maximiser and Schroder UK Income Defensive funds, all three of which employed a covered call strategy. John also specialised in trading and managing derivative securities for a range of structured funds. Previously he worked as a performance and risk analyst for Bank of Ireland Asset Management UK. John is a CFA Charterholder.

Larry Furness
Larry joined RWC in August 2010 as a graduate recruit and currently works in the Equity Income Team. He graduated from the University of Nottingham in 2009 with an honours degree in Economics and during his tenure successfully completed two intern positions; the first at Permal Investment Management where he was involved in manager research for the firm as an Investment Analyst, and the Government Economic Service as an Assistant Economist. Larry is a CFA Level II candidate.

Jaakko Kinanen
Jaakko joined RWC's Equity Income Team in September 2015 from Northleaf Capital. Jaakko was an Associate within the Private Equity team at Northleaf, where he focussed on secondary private equity transactions. Prior to this Jaakko worked at the Bank of America Merrill Lynch as a Senior Analyst within their Investment Banking division in London, and at AIM Capital in Helsinki before that. Jaakko graduated from the Aalto University School of Economics with an M.Sc (with Distinction) in Finance. He is fluent in Finnish and English.

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