Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Proxy Voting – Nudging Progress

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As long-term investors with an owner's mindset, we value the role that proxy voting can play in enhancing long-term investment returns—and the increased attention paid to it by company boards and management. This means we do not outsource proxy voting and never have.

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Ever since we started running money, our portfolio managers have sought to vote in a prudent and diligent manner and in the best interest of our clients, consistent with the objective of maximising long-term investment returns. Our proxy voting is predominantly related to governance issues such as management incentives and director appointments. We also consider how to vote on proposals related to social and environmental issues on a case-by-case basis by determining the relevance of the issues identified in the proposal and their likely impact. We generally support proposals that, if implemented, would enhance useful disclosure or improve management practices.

The ongoing evolution to multi-stakeholder capitalism, tightening stewardship code requirements, the increased number of signatories to the UN Principles for Responsible Investment (UN PRI) and greater flows into sustainable funds have led to a significant change in investor voting behaviour among owners of public companies over the last two decades. The Harvard Law School Forum on Corporate Governance calls this heightened scrutiny of corporate governance almost revolutionary: it has "amplified proxy voting as an important part of the dialogue between companies and their shareholders … voting is no longer a compliance exercise".[1]

"We see proxy voting on behalf of our clients as both a major privilege and a serious responsibility."

[1] Source: Harvard Law School Forum on Corporate Governance, "The Long View: U.S. Proxy Voting Trends on E&S Issues from 2000 to 2018", published 2019.

As a result, ESG (environmental, social and governance) considerations and transparency around positions on topical issues have risen up the agenda for companies and their stakeholders. According to leading proxy voting provider Broadridge,[2] "From climate change to racial injustice, expectations that companies will take these matters seriously have never been higher." Over five years to 2021, support for shareholder resolutions steadily climbed, from 34% in 2017 to 40% in 2021.[2] Many shareholder proposals were no longer simply blowing in the wind, for example The Children's Investment Fund's "Say on Climate" initiative has taken root remarkably swiftly.

Breaking records in 2022

The 2022 U.S. proxy voting season has seen a record-breaking 924 shareholder proposal submissions, significantly exceeding the 2021 bumper year.[3] A large American technology company, for example, received a mighty 17 shareholder resolutions for its 2022 annual general meeting (AGM). This voting season has been particularly active on ESG matters, and several social-related proposals have attracted significant support for the first time, including those addressing racial equity, sexual harassment concerns and gender pay equity.[2] Interestingly, majority support has been more muted this year, particularly for environmental proposals that were seen as too prescriptive.[4]

Other changes are afoot. Ahead of legislation introduced this May to the U.S. Senate around voting on index investments, one global investment firm made headlines by offering pass-through voting to institutional clients in some of its index strategies. So not only have demands on corporates increased, but the share of voice is also broadening beyond a clutch of dominant managers of passive investments.

Overcoming the hurdles

Despite these broad industry developments, challenges to effective voting remain.

Firstly, there is often an information gap. Management may not disclose all the information needed to place an informed vote. That's why we firmly believe in the twin roles of engagement and voting. As fundamental managers running concentrated portfolios and representing meaningful client assets, we are fortunate to have better-than-average access to company management. We are well positioned to develop long-term relationships with investee companies, and our portfolio managers have constructive, often multi-year dialogue with them. We typically have the opportunity to explore the proxy agenda with the company ahead of the AGM—sometimes at their invitation.

We are often asked for comments on pay plans. In the case of an Anglo-Dutch consumer goods company we own, we had been engaging with them on executive compensation for some time and voted against their pay plan where we didn't see sufficient progress. We had urged them to drop the use of earnings per share (EPS) targets, which we dislike as they can encourage a short-term mindset including leveraged acquisitions that may not be in the best long-term interest of shareholders. We had also pushed for the quantum of pay to come down after weaker profit performance. Recently, we were pleased to see total pay reduce by 35% this year and that they have dropped EPS targets and have now included ESG-aligned incentives, which we had requested.

We are also asked about issues that may impact shareholder returns in the long term as companies face the prospect of paying for the externalities of their businesses. For example, we spoke in detail with an American multinational consumer goods company on sustainable forestry and its approach to the manufacture of paper tissues and towels ahead of a shareholder resolution on the topic. While we were encouraged by the company's commitments to improve, engagement had furnished us with a more considered view and we voted in line with the resolution, demanding greater disclosure around deforestation.

The second challenge is that resolutions require proper scrutiny, as *the precise wording matters*. This is especially true of shareholder proposals. For example, earlier this year, a shareholder proposal urged a multinational medical device company to report on antimicrobial resistance. At our pre-AGM discussion with the company, we learned that it does not have a material exposure to antibiotics, making this proposal redundant where this company was concerned. We therefore voted against the proposal.

Third, *diffused ownership can mean that effecting change through voting can be difficult* in practice. We are a well-resourced team, enabling our portfolio managers to engage directly and vote our own proxies. And, in some instances it can be helpful to work in collaboration with select partnerships on particular topics. For example, we are currently involved with FAIRR—a leading collaborative engagement non-governmental organisation focusing on delivering a sustainable food system.

Where can voting bite?

What kind of critical mass do you need to drive change? Voting in line with management is generally high. According to Broadridge,[5] in 2021 the average shareholder support for directors was 94% and for say-on-pay proposals was 88%, broadly steady since 2017. (In contrast, over the last 12 months only 59% of our votes for our global portfolios were in support of management on say-on-pay, thanks to diligent analysis using our proprietary framework, the

[2] Source: Broadridge Proxy Pulse 2022

[3] Source: Harvard Law School Forum on Corporate Governance, "An Early Look at the 2022 Proxy Season", published 7 June 2022.

[4] Source: Financial Times, "BlackRock pulls back support for climate and social resolutions", 26 July 2022.

[5] Source: Broadridge Proxy Pulse 2022 (on 2021 proxy voting season)

Pay X-Ray.)[6] That said, a vote doesn't actually have to fail for a "vote no" campaign to achieve results. PricewaterhouseCoopers (PWC) observes that if support drops to the 60s or 70s, "it sends a stark message about shareholder dissatisfaction. It also generates media scrutiny and can affect a director's reputation."[7] Last year, while more directors stood for election, more also failed to attain majority support or to surpass this 70% support threshold.[2]

Nudging outcomes

Fitness tracker bands that nudge the user to take a targeted number of steps a day enable them to get fitter over time. That's the concept behind Thaler and Sunstein's 2008 Nudge theory, which revolved around interventions, big and small, that succeed in getting people to act in their long-term best interest and avoid what the authors call "sludge" in decision-making. Some shareholder proposals are designed to make a splash and some investors seek a more public, activist agenda for proxy voting. That's not our style. We believe that you can't solve systemic issues overnight and engagement, partnered with proxy voting, is a marathon rather than a sprint. Through dialogue with management focused on material risks and opportunities to the long-term economic success and durability of a franchise, we want to see a company establish stronger building blocks to tackle a particular challenge—for example, decarbonisation. And in so doing, we hope to nudge progress over time.

A look back at our team's 2022 voting season[8]

Given the second quarter sees the bulk of voting activity and AGMs, it's opportune to reflect on the last 12 months to 30 June 2022. We are not afraid to disagree with management and third-party proxy advisers, such as ISS. In 80% of all meetings held with companies across our global strategies, there was at least one vote cast against management. In total across our global strategies, 13% of all votes were against management recommendations and 8% of votes were against ISS recommendations.

When we receive any environmental- or social-related shareholder proposals, we carefully consider how to vote on them by determining the relevance of the issues and the likely impact. Across our global strategies, we saw 44 ESG-related shareholder proposals across topics including climate change, diversity, and employee and shareholder rights. Overall, we supported 64% of shareholder ESG proposals across our strategies and voted against management in 64% of cases.

There were also a number of resolutions relating to shareholder rights where, for example, we voted in favour of lowering the minimum ownership threshold to call a special meeting. We believe that lowering the threshold would enhance shareholder rights and allow important issues to be raised with management.

Beyond resolutions, executive pay remained a key focus. We voted against 41% of management say-on-pay resolutions for our global strategies. Additionally, where we have had long-standing unresolved concerns over pay, we voted against members of remuneration committees to make our message heard. We also voted against nomination committee members if we have had concerns over diversity. In total we voted against 15 directors in the last 12 months.

[6] Source: MSIM International Equity Team. Data from 01 July 2021 to 30 June 2022 across the team's global strategies.

[7] Source: PWC The Director's Guide to Shareholder Activism, July 2021

[8] Source: MSIM International Equity Team. Data from 01 July 2021 to 30 June 2022 across the team's global strategies.

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