FEATURED INSIGHTS

Stewardship: A catalyst for maximizing long-term value

Key takeaways:

- Stewardship helps us deliver long-term value to our clients and meet their expectations that we invest responsibly and sustainably.
- How critical is stewardship? We’ve elevated it to a firm-wide platform, complementing our fundamental investment teams’ research.
- In this piece, you’ll see real stories of how we build relationships with leaders of the companies we invest in, and how we vote on proxy issues.

We view stewardship as an opportunity to form meaningful connections with the leadership of the companies we invest in. Why? For the good of our clients as long-term investors.

On any given day, the leadership of a company is weighing tough decisions about issues that affect the firm’s ability to operate, generate value, and sustain long-term profitability. Many of these decisions involve important aspects of business strategy or material environmental, social, and governance (ESG) issues. Each of those issues carry a bundle of financially material risks and opportunities that will ultimately affect our portfolios—and, in turn, our clients’ assets.

As stewards, we can be a valuable sounding board to the leaders of the companies we invest in. We can be an advocate for more transparency and disclosure, a supporter of positive change, and a seeker of accountability from those who’ve committed to us that change is underway. And when needed, we can be an influential partner that is dedicated to advancing wise decision-making within our investee companies through:

- Our engagement with company leadership
- Our proxy voting actions
- Our own key decision of whether or not to invest or remain invested

In this piece, we’ll illustrate examples of stewardship in action at Wells Fargo Asset Management (WFAM).
Stewardship’s deep roots within WFAM

Stewardship is enjoying a well-deserved round of visibility in the financial news, driven mainly by large asset management firms seeking to differentiate themselves as active owners. Our commitment to active investing and deep fundamental research means that stewardship is an integral part of our investment process. It enables us to:

- Have a voice and exercise ownership rights to improve disclosures and transparency
- Affect corporate activities, policies, and behaviors that can generate attractive, long-term, risk-adjusted returns for our clients.

We believe that, to truly know a company’s practices, you need to speak with their leadership, build trust, listen for indicators of sound strategy and competence, and closely monitor them. We execute our approach to stewardship in two key ways.

Engagement

We build and foster relationships with management and the board of the companies we invest in or are considering as investments. As long-term investors, we look not only at the attractive features we see in a company today but also at how we can engage over time to help drive continual improvements in the company’s operating, financial, and sustainability performance. We ask tough questions and listen closely to the answers. We hold leaders accountable for their promises and praise them for smart, value-generating decisions. This is, and always has been, a key part of our due diligence processes.

Proxy voting

We see proxy voting as a major opportunity to advocate for strong corporate governance and in turn generate long-term value. We vote more than 6,800 meetings and over 65,000 proxy items a year. While the majority of proxy votes pertain to corporate governance issues, the number of shareholder proposals related to environmental and social topics has grown in recent years.

A mining company engagement uncovers commitment to safety and sustainability

We had been engaging with a large mining company in Africa for several years. One of its mining operations was particularly troubling due to concerns ranging from poor community relations to environmental damage. Recently, the mine was blamed for the polluting actions of small-scale, often illegal, mining groups that, for example, had no qualms using arsenic in their operations. I traveled to Africa as part of our regular research process, which included evaluating this company’s environmental, safety, and community practices. I felt this trip was important to assess first-hand the quality of the operation’s management and processes.

Mining is a dirty business and yet the facilities I toured were impressively run. Particularly, the muddy embankment used to store mining by-products was carefully monitored and maintained. In fact, it was home to a range of plants and wildlife, suggesting limited presence of pollutants. As giant trucks with tires taller than me roared by carrying tons of ore for processing, I was struck by how local management took great pride in their work. We stayed overnight at the mine’s guesthouse (that’s how clean and safe it was). In the morning over breakfast, geologists told us about the trove of data they monitor to ensure operations are safe and sustainable. We came away with a better understanding of the complex interactions between large mining firms, the environment, and the local communities in which they operate. This type of on-the-ground engagement gives us a better view of the long-term risks and opportunities in the investments we hold for our clients.
Stewardship’s present and future at WFAM

Stewardship is essential to the long-term value of our investments. Therefore, we’ve elevated it into a firm-wide platform to complement the strong fundamental research of our investment teams.

Throughout our history, WFAM’s fundamental investment teams have focused primarily on two factors—sound governance and business strategy—as critical drivers of a company’s long-term operating and financial performance.

We believe our Stewardship team—through its people, processes, and technology—can provide an important complement to the fundamental teams’ depth and strength by applying our additional perspective. We think of it as a materiality lens that captures insights on the ESG issues that are financially and operationally material to investors.

Following are three key enhancements to the stewardship platform at WFAM:

1. Uncovering financially material issues with vended and proprietary ESG research
2. Collaborating in a deliberate, patient, multifaceted engagement framework
3. Connecting global expertise through technology

Figure 1: Complementary focus: A more complete approach to engagement

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<tr>
<th>Fundamental team focus</th>
<th>Stewardship team focus</th>
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<td>Core business</td>
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<td>Business strategy</td>
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<td>Integrated reporting and other disclosures</td>
<td>Board independence</td>
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<td>Workforce diversity</td>
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<td>Human capital management</td>
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<td>Labor rights</td>
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<td>Data security, privacy</td>
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<td>Governance</td>
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<td>Audit and accounting</td>
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Engaging a retailer on sustainability disclosures, increasing diversity, and reducing carbon emissions

As stewards, we are proud when the leaders we trust show real progress on their stated visions. It validates our engagement efforts. Our team finds itself nodding with approval as the CEO of a major auto parts retailer provides updates on our engagement calls. When he took over in 2016, only one of his direct reports was a woman. He’s since increased that representation to half of his direct report team. In our last call, the CEO’s investor relations team previewed plans to publish the company’s first-ever environmental sustainability report, giving greater transparency to its ESG efforts. That report is now live, and the company is reporting promising metrics such as a 7% reduction in carbon emissions. Now the CEO wants to tackle improving his company’s supply chain reporting and disclosure of quality control processes—two areas flagged by ESG rating services. Improving those ratings would be a positive outcome. However, we know this leader’s actions stem from his belief that doing the right thing and enhancing business performance are intertwined. That’s the quality of vision we’re looking for in our engagements.
1. Uncovering financially material issues in data

We mentioned the connection between seeking strong governance through our stewardship efforts and focusing on the issues that are key to generating long-term value for our clients.

With that connection in mind, we align our engagement efforts to financially material issues, including sustainability disclosures and issues that are reasonably likely to affect a company’s financial condition or operating performance (and therefore are most important to a company’s long-term investors). A careful study of these issues reveals patterns. You can better understand a company’s exposure to certain ESG risks by knowing the likelihood of a financially material event happening in the company’s given sector or industry.

When we understand the financially material risks and opportunities that ESG issues present within and across sectors and industries, it helps us:

- Screen our investment portfolios for engagement opportunities
- Monitor the practices and progress of investee companies

This is where our close, multiyear support and partnership with the Sustainability Accounting Standards Board (SASB) comes into play. The SASB’s mission is to help businesses around the world identify, manage, and report on the sustainability topics that matter most to their investors. In late 2018, the SASB codified specific standards for 77 industries. It’s purpose: identify key sustainability topics that pose financially material impacts on a typical company in those industries worldwide.

Our Stewardship team embeds the SASB standards into its research and recommendations for our portfolio management teams as part of a multifaceted engagement framework.

Figure 2: Charting the financially material impact of ESG issues by sector

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<th>Consumer goods</th>
<th>Health care</th>
<th>Infrastructure</th>
<th>Technology</th>
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<td>Ecological impacts</td>
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<td>Data security</td>
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<td>Employee health &amp; safety</td>
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<tr>
<td>Supply chain management</td>
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- Issue is likely to be material for more than 50% of industries in the sector
- Issue is likely to be material for less than 50% of industries in the sector
- Issue is not likely to be material for any industries in the sector

Source: This table is based on a subset of the SASB Materiality Map

A proxy vote aimed at delivering maximum shareholder value to clients

A health care firm in Asia recently put itself up for sale. Such transactions can benefit long-term investors, but the bidding process must be competitive, fair, and priced to achieve an attractive valuation. Unfortunately, the company’s management and board had ensured none of that.

We engaged with management and learned they were dead-set on accepting the first bid already received. In our opinion, it was far too low. When we asked, “What is your rationale?” the folks across the table had no credible answer.

It turned out the board was controlled by earlier promoters who, at this point, had very little stake in the business and collectively were mismanaging a crucial step to the company’s recapitalization. This is a key example of how a proxy vote can be a crucial tool for effective stewardship.

Other asset managers we spoke with were likewise not happy and collectively voiced concerns. Soon, a proxy vote arose proposing that the firm replace the board members in question. We voted to remove them, against the company management’s recommendation. Not long after, some new independent board members stepped in, the bid was reopened competently, and shareholders benefited from a much higher sale valuation relative to the initial bid. In cases like these, the value of speaking up is passed on to our clients, and we’re proud to take action when needed.
2. Collaborating in a multifaceted engagement framework

At WFAM, our portfolio managers’ bottom-up approach converges with the top-down research of our dedicated and growing Stewardship team. The collaboration happens in three forms of engagement:

**Sector-specific:**
When engaging with companies in a specific sector, we discuss environmental and social issues inherent to their industry while encouraging them to use the SASB’s standards to improve how they disclose material metrics.

**Company-specific:**
We also engage directly with companies involved in controversies arising from incidents of wrongdoing or from societal debates relevant to the company’s products, services, or policies.

**Multisector:**
By identifying themes that apply to various sectors—for example, board diversity or data privacy—we engage with companies that are laggards in addressing these issues and recommend ways they can improve.

To inform these three approaches, our Stewardship team researches material ESG issues with a rotating focus across and within market sectors that could significantly affect our ability to generate value for our clients. The team also monitors our portfolios’ holdings to identify companies where engagement has the highest impact potential. Using these insights, our portfolio management teams collaborate with our Stewardship team to engage with companies whose relationship with WFAM falls into all of the following categories:

- We have substantial holdings in the company.
- We own a significant portion of the company relative to its market capitalization and bond issuances.
- The company’s holding is significant to a specific investment strategy and/or team within WFAM.
Together, our investment and stewardship teams are working to deliver long-term value to our clients through improved investment outcomes that we believe good stewardship can provide.

Jessica Mann, CFA
Head of Stewardship

3. Connecting globally—spanning expertise through technology

Sharing insights about a company that might be an overlapping investment among our 29 autonomous investment teams may be challenging. However, it presents immense potential to maximize the value of our collective knowledge with one another.

We are implementing a data-driven technology platform that can enable our Stewardship and portfolio management teams to enhance the way they communicate on company engagements and share their respective insights from those engagements, forming a mosaic of insights from potentially different stakeholders.

Capitol Hill update: Scrutiny of proxy vote system

The Securities and Exchange Commission (SEC) held a roundtable in late 2018 to discuss proxy voting issues and challenges. Shortly thereafter, the Senate introduced the Corporate Governance Fairness Act, a bipartisan bill that would require the SEC to regulate proxy advisors. However, the proposed bill had a short life in the waning hours before the last Congress expired. It did not advance and would need to be reintroduced to the new Congress.

We’re closely monitoring these discussions, as any direction the SEC decides to take could bear implications for the asset management industry; ourselves; and, in turn, the portfolios we manage. Here’s a summary of the SEC’s threefold agenda:

Regulatory status of proxy advisors as fiduciaries (for example, ISS & Glass Lewis)

The primary focus was on the major proxy advisory firms—the two largest jointly control 97% of the proxy voting market share—and the desire for more robust regulatory oversight. The discussion centered on the desire to require the largest proxy advisors to register with the SEC under the Investment Advisers Act of 1940. Given these firms have evolved to be an essential tool for investors, this would ensure they are well-regulated and accountable as fiduciaries.

Shareholder proposals

Most participants viewed the current shareholder proposal system as relatively smooth functioning. In the current rules, investors must own more than $2,000 in shares or 1% of a company for the right to raise a proposal—or, in other words, for the right to exercise their voices. The SEC is reviewing the entailed threshold level with an eye toward increasing it.

There are pros and cons to consider. If the threshold is too low, proposals could spike in volume, bogging down shareholders in a sea of proxy issues to review—many of trivial importance. If the threshold is too high, then individuals who should have a voice could find themselves excluded from raising legitimate concerns.

Proxy voting mechanics and technology

The SEC and roundtable participants suggest that modern-day proxy “plumbing” is outdated, leading to inefficiencies, opaqueness, and inaccuracies. They view the system as patched together and requiring fundamental rethinking and the potential for modern technologies to improve it. The participants proposed near-term solutions such as routine and reliable vote confirmation and guidance on reconciliation.
Most recently, the U.S. Department of Labor formally joined the fray with a directive to review and report on proxy processes. President Trump signed an Executive Order on April 10, 2019, focused largely on reviewing policies affecting energy companies. However, it also included a requirement for the Secretary of Labor to review the current proxy processes with respect to fiduciary duty as defined by ERISA. This puts the proxy process under the scrutiny of yet another U.S. governmental body, in addition to the SEC’s ongoing activities. The findings and recommendations are set to be delivered by mid-October 2019. What are the implications? The retirement and asset management industries should expect potentially significant changes to the proxy process for the first time in 15 years. This means plan sponsors, asset managers, and service providers such as proxy advisors must be prepared to adapt accordingly.

Cracking the code to effective stewardship

More than 50 countries have created codes defining what stewardship means and what principles long-term investors should incorporate into their investment processes. The right code—when aligned with an investor’s principles—empowers its signatories with a framework to guide them. Each code is distinctive, but many require dedication to the following practices:

- Creating and maintaining an engagement policy, disclosing priorities and activities with investee companies, and monitoring success
- Creating and maintaining a voting policy for proxy issues and disclosing voting records
- Defining how ESG factors are considered in engagement and proxy voting activities to promote long-term sustainability

We are reviewing various country codes with an aim to expand our signatory status globally.

Final thoughts

Together, our investment teams and the Stewardship team are working to deliver long-term value to our clients through improved investment outcomes that we believe good stewardship can provide. We regard stewardship as integral to our investment process and a clear way that we deliver on client and community expectations to invest responsibly and sustainably.

In 2014, Japan’s government launched a major initiative to revitalize its economy, strengthen Japanese companies’ corporate governance to international standards, and attract more global investors. As part of this effort, the government created the code to help establish good governance standards in Japan. The code also exists to influence how investors—both asset owners and asset managers—can seek more transparency, engage with companies to influence positive change, and drive long-term shareholder value.

WFAM is a proud signatory of Japan’s code. It’s recognized globally as a leading stewardship framework and has helped enhance the quality of engagement between investors and companies.
We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us:

- To reach our U.S.-based investment professionals, contact your existing client relations director, or contact us at WFAMInstitutional@wellsfargo.com.
- To reach our U.S.-based intermediary sales professionals, contact your dedicated regional director, or call us at 1-888-877-9275.
- To reach our U.S.-based retirement professionals, contact Nathaniel Miles, head of Defined Contribution at Wells Fargo Asset Management, at nathaniel.s.miles@wellsfargo.com.
- To reach our international investment professionals, contact your regional client relations or sales director, or contact Ben Foley at either ben.foley@wellsfargo.com or +44 20 7518 2947.
- To discuss environmental, social, and governance (ESG) investing solutions, contact Hannah Skeates, global head of ESG at Wells Fargo Asset Management, at hannah.skeates@wellsfargo.com.