

Global Equity Observer

A Quality Guide to Governance

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We believe that good corporate governance is crucial, as it is necessary to ensure that management acts in the interests of the shareholders. It is needed to deal with the classic principal-agent problem, in which shareholders do not manage the company they own, thereby exposing themselves to the differences in agendas between management and shareholders. The typical differential is one of timescale – managing the company for the ultra-long-term, regardless of profitability or returns (a classic Japanese problem), can be as bad as running it for short-term profits, often to be paid more (a classic Anglo-American problem). Clearly, investors need to be on their guard.

It is vital that companies are managed for the long term rather than for short-term profitability. In particular, they need to make sufficient investment to sustain their franchises, in innovating and where relevant backing those innovations through advertising and promotion. These investments are financed through both the P&L and via capex. It is also crucial that any spare free cash flow that is left over is invested at high returns, or in the absence of such opportunities returned to shareholders, preferably through dividends. Business areas without the prospect of long-term acceptable returns should be exited and the capital deployed into higher-return areas or returned to shareholders. While there are some decent acquirers, we remain generally wary of large takeover deals as they tend to be a transfer of value from the acquiring shareholders to those lucky enough to have been bought. recovery in demand for its products It may seem counterintuitive, but our view is that governance is even more important in high-quality

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“...our view is that governance is even more important in high-quality compounding companies.”



compounding companies. This is simply because management has more degrees of freedom. Amongst Consumer Staples companies, there are large advertising budgets that can be trimmed in tricky years to inflate short-term profits at the cost of long-term franchises, while high-return companies should generate large quantities of free cash flow, with all the temptations for misallocation that involves.

Analysing management and governance has been a core element of the International Equity Team's process since its founding way back in 1986. Work in this area is not outsourced to the likes of ISS and Glass Lewis, but rather done by the investment team itself, supported by the MSIM Corporate Governance Team. While we have clear preferences, discussed below, decisions on voting are made on a case-by-case basis rather than some box-ticking formula. In a deeply imperfect world, we do not want our search for perfection to get in the way of what is reasonable, particularly when the reasonable is improving year-on-year. That said, we are very comfortable voting against board recommendations, and even against board members themselves, where we believe it is required.

In terms of structure, we prefer the chief executive officer and chairman roles to be separate, and ideally we like the idea of a senior independent director to go to when we are unhappy with both of them. More broadly, we do not like poison pills, double voting rights for some shareholders or differentiated share classes. We do not believe that companies, and in particular managements, require protection from the companies' owners.

Executive pay is a focus, as most people tend to do what they are paid to do, meaning that the incentives need to reward behavior that is in the interest of shareholders. This makes us wary of excessive reliance on earnings per share, as it can be manipulated by short-term manoeuvres, in particular increases in leverage and/or low-returning acquisitions. We are especially wary of the use of 'adjusted earnings,' or as we prefer to call them 'earnings before the bad stuff.' The bad stuff may be write-offs, the costs of environmental or social blunders or even paying people in shares. In contrast, we welcome the (sadly rare) inclusion of return on capital targets.

One of our goals is avoiding high pay for ordinary or poor performance. As such, we look for stretching goals, rather than easy targets or shares just for time served. Another red flag is moving the goal posts, for instance discounting the effect of currency when it moves against the management, often having taken the benefit when it went the other way. We also frown on targets that are met through acquisitions. We do support minimum levels of share ownership for executives, but actually go further, encouraging companies to keep these targets in place for a period after executives' retirements, to avoid the temptation to plump up the business unsustainably at the moment of exit.

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Ultimately, while the structures do matter, it is the culture of the organization and the behavior of management that matter more, which is why meeting management regularly is so important. Much of the 'governance industry' concentrates on scoring what is easily measured and ends up ticking boxes, neglecting the human element. The danger is that the process ends up like the story of the inebriated man looking for his keys under the lamppost because that is where the light is shining. Our more complex, labour intensive and necessarily subjective process attempts to search where the keys actually are.

RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in

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DEFINITIONS

Earnings per share is the portion of a company's profit allocated to each outstanding share of common stock.

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