CFA Institute

ASSET STEWARDSHIP FOR LONG-TERM VALUE CREATION

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In this presentation, Rakhi Kumar answers the following questions: As permanent capital owners, do large index managers have a responsibility to turn passive investing into active ownership by engaging directly with companies in the index on long-term strategic objectives, including environmental, social, and governance issues? How can large index managers help bridge the agency gap that comes with investing in an index by becoming long-term asset stewards on behalf of index investors? How might doing so affect the overall quality of the indexes and the broader economy? From a practical perspective, how can long-horizon asset owners and managers work with companies to create sustainable value creation?

Kurt Schacht, CFA: I'm Kurt Schacht. I'm managing director at CFA Institute in New York, and I'll be moderating this session. Today we're going to talk about this wonderful issue of stewardship, in particular in the context of the indexed investing realm. So we're very excited about that. Please feel free to use the online chat feature if you have any questions to pass those along to our speaker today.

So, good afternoon. As I mentioned, this is our session on the investment business of indexing and the issue of stewardship. I'm absolutely fascinated by the evolution of this topic over the years, in terms of the size of this industry, the indexing business, as well as the fact that it's become sort of the go-to strategy for lots of institutional investors, lots of retail investors. There's been a vast amount of specialization with index products, and how dramatically it has changed the ownership structure of publicly traded companies.

Indexed AUM has grown from about $11 million in 1975 when they first started tracking this to over $4 trillion this last year in 2015. They have had just an incredible growth spurt. If you look at the index mutual funds and ETFs, there are now about over 6,500 products globally on 60 different exchanges around the world. Last year in 2015, over $20 trillion in market value was traded, which is more than the gross domestic product of the United States.

Jack Bogle says — the former Vanguard CEO — says that this was the greatest marketing invention in the 21st century as it relates to investment management. And he says, this is like handing retail investors — it's like handing a match to an arsonist, in terms of retail investors using these products to day trade. So there's lots of controversy, lots of interest around this topic for sure.

One of the world's renowned leaders in index products, with the iconic S&P SPDR — the 11-sector sector SPDRs — State Street Global Advisors — certainly knows something about this remarkable sector of investment management. With us today is Rakhi Kumar, who is the managing director and head of the corporate governance area at State Street Global Advisors, who is responsible for the very important component of this indexed industry, and that is the aspects of how these very large and permanent capital owners attend to the issues of ownership.

So thank you for joining us, Rakhi. It's nice to have you with us today. Tell us a little bit more, if you would, about the State Street Global business. It has both active and passive investment products.

Rakhi Kumar: Yeah, thank you very much. Good afternoon, everyone. So State Street is one of the three largest asset managers in the world. We have about $2.2 trillion of assets under management. We are number one with US endowments and number one with central banks. We are a large ETF provider as well as pension fund managers for both the DC and DB space. And you're right — we do have active and passive strategies.

We believe we need a mix of both — investors need a mix of both these strategies to reach their investment objectives in this "lower for longer" environment. And really, we work with our clients to build diversified, risk-aware portfolios that really are suitable for their risk–return objectives. And our suite — we have traditional passive products, we have smart beta exposure products, we have active strategies, and we use a combination of this with different investors to help them achieve their objectives.

Kurt Schacht, CFA: Thanks. We hear more and more about the big inflow of assets under management into passive, [that] it's going to far outpace the inflows into active over the next several years, so even bigger pools of passive investment. Are you seeing that trend at State Street?

Rakhi Kumar: Yes, yes. We are absolutely seeing a lot of money move from active to passive strategies. Having said that, it's important to remember that passive investments still account for only about 20% of all third-party managed assets in the world. So while it's growing, it's about 20% overall, globally. But year to date, Morningstar reports that US passive equities have reached about 40% of — passive equities have reached 40% of US equity funds, up from about 18% 10 years ago. Global ETF, currently, is at about $3 trillion. It's expected to reach about $5 trillion by 2020. And more than 25% of all US bond fund assets are now in passive vehicles, up from less than about 10% about 10 years ago.

Kurt Schacht, CFA: You know, we're talking about ownership today, and I think one of the interesting questions for you is, is there a difference — you have both active and passive assets under management. And the question I have is, regardless of it being active or passive investor capacity, is there a level of active ownership in both — I would expect — and what are the differences?

Rakhi Kumar: Yeah, I think it's — so, as somebody who manages largely passive equity mandates, we vote everything one way, and we make one unified voting decision. I have an advantage because most of the active strategies we have are also long term in nature. And most of our clients, the asset owners, are also long term in their thinking, etcetera. But, having said that, there is a difference. And the difference — and a good asset-stewardship program really ties the stewardship program to the investment strategy.

So when you think about short-term investors or hedge funds, their investment — their ownership and stewardship program is going to look very different or non-existent. The active manager who is short term will have a different program. An active manager who's long term but has the option of selling will be different. So in these instances, you can integrate stewardship up front where you actually meet with the management and decide you want to invest in the company. That could be up front, or one could say that when you're actually selling the product, you've made your decision and exercised your asset-stewardship decision.

But in passive strategies, it's not integrated up front. Because the nature of passive index holdings, I'm holding the entire index, I'm invested in the good companies. And I'm invested in bad companies. I'm invested in outperformers and underperformers. And the nature of passive investing is, I am not going to sell. I'm a permanent capital in some ways. So the ownership process has to be part of the internal process, the investment process, right? And when you think about passive investment, the challenge, then, on a stewardship basis becomes prioritization. There's no way I can speak to 9,000 companies that I'm invested in globally. And the other bit is, I have to rely on negative screening to be able to identify and prioritize who I'm going to talk to in that process.

Kurt Schacht, CFA: You know, generally across the spectrum of passive, I think people worry about corporate management getting a free pass in terms of accountability, particularly as we move to more and more indexing. Let's talk a little bit more about that. If the vast majority of a company's stock is owned by a cadre of different index products around the world, who's left to hold the officers and directors accountable?

Rakhi Kumar: Yeah, so I think I think the underlying fear is that if the management knows that you have to invest in them and you can't sell with them, then they can ignore you, right? Having said that, passive investment doesn't necessarily mean passive ownership. And that's why we call ourselves passive managers with an active ownership program. There's also something interesting going on. We also have a vote, right? And we get to vote every year on important things like electing and re-electing directors on compensation issues, other things like mergers.

And so there is this mechanism. What I call it — the stakes on assets, in our asset stewardship — you have engagement, which I call the carrot; you can have a conversation and build relationships with management. And if it's not really — there's no responsiveness — then you use the stick, which is the vote. But that stick is an important stick, especially if you have large volumes. And in a very diversified ownership structure, you own about 3% to 5% of the company. So you have — if it's a one-share, one-vote issue, you have 3% to 5% of the vote.

And then you overlay that with the current environment, where you have activism going on, and the whole short-term versus long-term term investor. And as a long-term investor, you're aligned with the board, who wants to make certain decisions for the long term, and they need to rely on you. So it's as much for us long-term investors to build that relationship as it is for managers and directors to see us as partners and actually work with us to ensure that we are creating value in the long term. So I'm not very worried, because as long as we — we are not at passive owners, and that's the biggest difference.

Kurt Schacht, CFA: That's the difference. The question is, I'm sure, that State Street probably does a nice job of being — in terms of their proxy stewardship and other things like that. The question is, this is a vast indexing industry now. Do you think the others that are involved in this are as cognizant of the stewardship issues? Are you seeing — you probably interact with a lot of the other indexers in the industry.

Rakhi Kumar: So I'm not going to say anything about my competitors. Of course, I think I do it better. But I think what is more important is the fact that there is this — all of us have teams. All of us are engaging. Right? And all of us recognize the role we have to play in the market. And you will see a similar — in the last couple of years, especially — seeing a lot of similar rhetoric coming out from the long-term passive managers.

But I also — another thing is asset stewardship. It's not that passive managers don't have to do it, or the assumption is that active managers do it. It really comes down to the organization and whether the organization is behind the effort and they actually believe in this effort. So it's important to understand — I'm part of the investment team. We don't have — under passive strategies, you don't have a portfolio manager who's very involved in the day-to-day company, understanding the company. That's my job, and I represent a portfolio manager who's made that investment decision.

Because I need to — and some of my peers may have my role placed differently, could be a compliance function. So there are differences, but by and large, I think we, as passive managers, are aware of the role we have to play.

Kurt Schacht, CFA: Do you have a sense for how you rely on proxy advisers? How much influence do the proxy advisory firms have on indexed investors?

Rakhi Kumar: Yeah, so I can only talk about SSG in this instance. For ours, they're just a reference point, or they're just yet another recommendation, just like you would not invest based on bond rating. You would do your own homework; we do our own homework. So we look at many other issues. I would say in the last year or two, we've really realized there's certain areas, such as where you have to tie your vote decision to your investment strategy, we pull away from the recommendations of the proxy advisers.

An example would be — where we were tying it — and this is an example where we tie it to our investment strategy. So a few years ago, in 2014, we started noticing that debt — it's a macro issue. As an invest index investor, you're worried about macroeconomic issues that are coming up. So you saw a lot of debt coming up on the balance sheets of emerging market companies. We have a vote in emerging markets. In China and India, you actually have to allow companies to leverage up, right?

Kurt Schacht, CFA: Some of the proxy solicitors, their view on supporting that vote is, as long as you're proportional or you're taking on — so the specific vote is, you have a company. It has to give a loan guarantee to a subsidiary which is not listed. And the recommenders or proxy advisory services, their view is, as long as you're assuming a proportional aspect of the loan, they're fine. And we said, just wait a minute. What's your leverage? How leveraged are you that you're taking on additional debt on loan guarantees you're going to be holding?

Rakhi Kumar: And we changed — our policies are based on averages plus some buffers, and then we vote against. And what we found is that the advisers were approving or allowing companies that had 1,000% leverage to take on even more debt or loan guarantees. And we voted against 55% of all loan guarantees in these countries. So that's an example of where you really have to work the strategy and understand who you are and use your vote to align it.

Kurt Schacht, CFA: Did you get a sense, though, that other proxy voters — indexers, in particular — rely quite heavily on their proxy advisory services to cast their votes? Or do they go through that same sort of analysis as just another data point?

Rakhi Kumar: Again, I haven't really discussed each item on voting issues with them, and I really don't know internal processes, so I can't talk about this. But I do have to say that we've spent a lot of time trying to identify these kinds of issues, where — and they're unique to passive managers, right? Because my time horizon is very, very long. I'm going to be held holding — left that bag at the end of — And I can go on. I have examples in the US where some advisers have advised — because a company is going into liquidation and you need to stay in the current company at all costs. They have agreed to let a director come on the board who doesn't have — and asked that the shareholders remove the right of loyalty.

And in the proxy, it states that this director is conflicted, which is why you have to — and so I'm like, I'm not going to do that. Because if I do it right now, five years from now I'm still going to be an investor; and if you save the company, I'm going to just buy more of that company. So I have to keep that sanity check when it comes to — which I'm not sure proxy advisers can even do. Because they would have to start saying, if your time horizon is this, then vote this way. If your time horizon is this, then we vote this way. And I'm not sure that they're there as yet.

Kurt Schacht, CFA: Interesting. There's lots of discussion about whether these advisers have too much power, whether they should be more regulated. Do you have any thoughts on that?

Rakhi Kumar: No, I think they do provide a service, and they do provide. But we have to understand that we cannot outsource — that their job is not to tell that you — if you are outsourcing a stewardship responsibility to them through the vote, then shame on you as an asset manager. It's not about — they're just doing the job of being a recommender. And I think that we need to understand that. And it needs to be a part of a process. It can't be the end game.

Kurt Schacht, CFA: Interesting. I think there's a lot of investment managers out there that actually do rely pretty heavily, almost uniquely and universally, on the proxy advice they're getting from advisers.

Let's talk a little bit more about who's going to be the best enforcer or accountability. We talked about being active. It certainly involves actively voting proxies. But what else do you think reasonably jives with your being the asset owner on behalf of lots of assets under management? Do you engage directly with the companies? Do you engage on things like ESG and so forth?

Rakhi Kumar: Yeah, absolutely. I think one of the biggest differences is that I'm starting to recognize, and it's playing out in the market, is this ESG factor, right? So it's environmental, social, and governance, and I think engaging. And often, we'll have conversations. So if I step back a bit and look at environmental, social, and governance factors, there really are low-probability, high-impact factors. So in the short term, you're going to say oh, the probability of this happening is very low.

Our entire disclosure in the US on reporting, on identifying your key risks, is based on probability, right? And so sometimes, the probability is so low that it may not even make it in your statements, MD&A statements. However, if you are a long-term investor with a forever kind of mentality — like, I'm going to be invested in you as long as you're listed — those ESG factors and probability in the ESG factors, they become more clear in present, and they need to be addressed. And they need to be talked about.

So it's more about having — it has to start with strategy. You have to understand if you have a board that it can set the strategy as well as execute that strategy. You also need to have confidence that the board is going to hire the right people to implement and oversee the implementation of the strategy. And finally, it's all about the risk mitigation and opportunities. Are they going to identify ESG as an opportunity risk? And, how are they going to manage that process, which is pretty important?

And one of the things on the ESG aspect is we, as long-term investors — and the CFA Institute has a role to play, too. The problem with ESG factors is they're very hard to quantify. Today, if we want to set a price or understand what risk is, we use DCF models, say for example. But how do you quantify the ESG risk, which is low probability? So we're starting to tackle this when it comes to climate change, for example. We're starting to come up with carbon pricing as a mechanism where you can start using a dollar value, assigning dollar value to the cost of either regulation or change, or whatever you want to call it, and then putting that into your model to understand, are you doing the right kind of capital allocation? Is your strategy — what are your assets, and those kinds of issues. So I think we really have to start thinking a bit more about, how do we value these, and how do we use that to get more effective pricing?

Kurt Schacht, CFA: In terms of engaging directly with companies in terms of how active you are, State Street has a wonderful advantage that it's huge, and so any investor relations department will take your call. I would suspect that many of the directors on a board of directors would take your call, certainly the officers of the company. That's a wonderful advantage of being the size and how important a vote you are to these initiatives.

Rakhi Kumar: Yeah, it's an important advantage, but it's also responsibility, because you are asking a director to come and spend time with you. You better make sure you're not wasting that person's time and you have something to say. And I think that's where our role of partnering and recognizing that sometimes investor — it's a changing environment. We all began engaging in the US and in, I guess, Canada less so. But with the Dodd–Frank bill, with the "say-on-pay" vote, that triggered a huge change in — and both companies are learning and investors are learning.

And I think what we've learned is that if we, as index investors, have an issue, we should just be explaining our position. I think investors don't do a good job explaining what they want. Because what I have found is, when you speak to a director, one, their responsiveness is amazing. Most — 99% of them — want to do the right thing. They're listening to their investors. But sometimes investors are just not clear as to what they want from directors.

Kurt Schacht, CFA: Would you ever file a shareholder proposal? You probably would certainly review and vet all shareholder proposals, and they can vote — but would you ever file your own shareholder proposal?

Rakhi Kumar: We haven't done any of that to date. I think that we are very clear — we manage money; we don't manage companies. If we did feel that a company was not responding, there are many ways for us to do it. One, as I said, we have a vote. If engagement fails, we have a vote. But we can also support shareholder proposals at companies where they need to be supported. And we have done that in the past. Where we felt the board hasn't been responsive, we will support shareholder proposals.

Kurt Schacht, CFA: I think my favorite point in our earlier discussion is how you've capsulized what it is you do in terms of creating long-term value and investment returns with the asset, versus using the assets to change values. I thought that was an interesting way to describe the distinction between being a value investor versus a values investor. Talk a little bit more about that.

Rakhi Kumar: Yeah, so I think I can use an example on this. So there's some investors who are values investors. So let's take the separation of chair–CEO. A values investor would say, I believe board effectiveness can only occur if — independent board leadership is possible only if the two positions are separated. So I'm always going to support it, and it's appropriate in every instance. And a value-based investor says, is this right? Does the company have a process in place to ensure that the board is independent and is overseeing it in an effective manner, even if the individual, if the chair and CEO positions are combined? Do they have the structure in place that we want? Do they have — it's a lot about the directors.

So we did a study of five or six different jurisdictions. In Europe, we had France, Germany. In the US, we looked at — I mean we looked at North America, we looked at the UK and Australia. And we found that there are some jurisdictions — just UK, Australia — that they separate the positions out. But when you look at the data, 48% of those positions were held by non-independent chairmen, right? So just that values, that you have to separate out the role, didn't quite make sense to us. And we developed a framework, which has many things, including evaluating the individual in playing that role; the governance structure around the role; and the job, the duties and responsibilities of the individual. And then we take a case-by-case approach. Believe me, it's easier just to say oh, I believe in this separation and I'll support it, vote it. But it's more work, but we think it's right in the context of who we are as investors.

Kurt Schacht, CFA: Excellent. You know that you can fill out these cards and ask questions of our guests today. I encourage you to do that. Here's an interesting one along this line from one of our audience participants. You're obviously, again, a big enough player that people answer your phone calls, but you also have enough resources to hire a staff to do this. You have lots of names in your portfolio. How big of a staff do you need to do this well, do you think? And how do you prioritize where you engage? Is it your biggest positions, or what do you do?

Rakhi Kumar: Yeah, so I think the staffing question is very interesting. Because I think if you asked — we have about we have nine people, of which five of us are involved in day-to-day engagement in voting and therefore operationally, who help make our lives really easy and help on the back end, and they do the busy work. But I think there are — one of the things we have done here at SSGA is actually used technology a lot. So I often get asked, how many people do you have? How can you do with X number of people? Your competitors have 20 people or 15 people, etcetera.

And I'm like, look — you got to see how my program's designed. So my goal — I'm telling you upfront — is not to talk to 9,000 companies. It's not to maximize the number of companies I'm going to talk to. It's about outcomes and risk management. It's risk mitigation. I own an index. So I start very clearly — who are the biggest risks in my index? And if I only focus on an absolute holding basis, I'd only be focused on the long term — I mean large caps.

So that I take a proportionate to their overall position, so it's a relative holding in a company. That also gives me access. So I start with the position of a risk-based approach to identify. The next thing to keep in mind is every country, every company does not engage. Country to country, you'll find different kinds of culture and exposure to engagement. So if I'm trying to engage with an Asian company which is 40% or 30% controlled by either the state or a family, I'm wasting my time to some extent. I'd rather use my vote and hold them to a very high voting standard.

Whereas in the US, where I'm a significant owner and I get access to management, let me spend my time there. Then let me see where my clients are really interested. I may do a higher than — if my portfolio is largely US, I'm expected largely US. But my clients in the UK do care about this. I'm going to have some weightage there. That's how you design the program. And then the last bit is technology. I do not need to have a person going for–against, for–against. You can use algorithms; you can use things to have a logic to be able to fill in most of these ballots that you're filling. We vote 14,000 meetings, over 100,000 ballot items every year. I do not need one person to do it. That's most inefficient. Let me use technology and then use my people to focus on the right things. So, I think it's about doing it smart.

Kurt Schacht, CFA: Well, your ideas for engagement — does it ever come from the investment staff? From a portfolio manager?

Rakhi Kumar: It can. So the way we do — actually, they're integrated to a point, so let me tell you. My assets do it every year. I have an asset stewardship program. In that program, I pick two to three sectors that I do deep dives globally across each issue. And we pick them based on macro issues that are starting to show up. So this year, for example, we have IT companies, IT sector. Because as you see what's happening with IT, there are really three groups of IT companies. Those which are now becoming more commodities, the semiconductors, etcetera, where they are starting to get activists — they need to control costs. Then you have the likes of the big — Oracles, the Microsofts, who are trying to reinvent themselves because PCs are dying out, etcetera, and what does that mean for their business. And then you have the high — the Facebooks, etcetera, who are dual class, but they have no — limited revenue but high valuations. And across the sector, you have pay as an issue. Then you have automotive. We've taken that in. And so we pick these sectors. So that, as a passive manager, within the three- to five-year time frame, I've rolled through my sector and provided oversight that I need to provide.

The other issue, we pick up thematic issues. And the thematic issues are — this year, for example, are board leadership, gender diversity, pay strategies. So I'm not just talking about compensation for executives, but I'm talking about how do your wage strategies tie in with the overall strategy — water and climate. And then this program gets approved by my investment committee. And then I'm provided — I go and execute that program.

Kurt Schacht, CFA: Talk a little bit more about your climate issues and what you focus on there.

Rakhi Kumar: Yeah, so it's interesting. Because climate has been — this year, we're really been engaging on climate for the past two years. We've had over 18 engagements globally with different companies. And we used the first two years to just learn and understand where things were globally. After the Paris Agreement, we published a paper. And it was very timely, because this is, in the US, the year of the climate proposals. There are over 100 — there are 89 climate proposals and another 20-odd proposals which are dealing with the environment.

So the one thing you'll hear about the whole season, at the end of the season, is climate. And what we did is we, as a passive investor, went out and said — up front — this is not a political issue for us. We're not debating it. We believe this is the risk, and we want you directors to ensure and oversee this risk, both from a physical perspective as to protecting your assets, but also from the perspective of protecting your strategy. How resilient is your strategy to climate?

And then we've provided guidance questions, because we want to work with directors. We don't have a "gotcha" mentality with directors. We've told them what we are expecting of them, and we're working and we're asking for access to directors to engage with them, to see how the board provides oversight on this risk.

Kurt Schacht, CFA: We talked about the "name and shamers," so you'll get ideas from clients. You'll get ideas from PMs. But what if one of these really open and notorious aggressive shareholder activists — what if Carl Icahn calls you up and says, Rakhi, you need to support us on this. How do you deal with those folks? Do they — will you take their calls, and how do you deal with it?

Rakhi Kumar: Absolutely. I'll always take a call from a proponent, somebody who wants to talk about change. I always am interested to hear what they have to say. I think there is a place for activist investors. Having said that, I think in the past, we outsourced our stewardship to these activist investors. But in the past two years, we've learned the whole short-term and long-term debate going on the market. We've educated ourselves, and we have far more sensitivity to the strategies and what is being asked of or what is being expected by these activist investors in terms of turning the company around. And if we feel it builds up risk in the long term, we are less likely to support them. And if we feel that it truly drives at the heart of creating long-term value, we will support them.

Kurt Schacht, CFA: Just in terms of when you think — the better enforcer of accountability, whether it's that group, and whether they can build a consensus amongst all of the indexers out there and get them to back their proposals. Or do you think that there'll come a point in time where the index crowd — your firm and others — will actually be more outspoken and more aggressive on this work? So the question is, who's actually the enforcer here?

Rakhi Kumar: Like I said, the capital markets have different kinds of investors, and there's a role for each and every investor to play in it. And I think for us, it goes back to tying into our strategy, our time horizon. I think we are starting to notice certain practices which are disturbing. And if I could give you some examples — so, we recently engaged with a company which had settled. And that's another thing that's happening. Companies are settling because they don't want to go and fight anything in the public. So we were engaging a company that had settled with an activist investor.

The activist was going to get a board seat coming this May, so this current — the meeting still has to be held. But the company got a vote against its say-on-pay proposal. And the company was going to put this activist investor on the call with me to talk about the issue. Now keep in mind, this individual is not even a director on the board as yet. And I said, absolutely not. What is their fiduciary duty to me when they're not a director? And how can I talk on behalf of your management? I want to talk to the chair of your compensation committee.

And the reason I asked for that conversation is to tell them, look, our problem with your pay is not the structure of your pay. Your structure of your pay, you're looking at the right metrics and the right drivers that I'm interested in as a long-term investor. The problem is the quantum of the pay — and that's what I'm struggling with. So the other thing I want to warn you is, I've seen the activist investors, when they come on board, they'll change your entire program to focus on EPS.

So EPS is my least-preferred metric as a long-term investor. Guess what the comp chair tells me? Oh, next year they're moving to an EPS-based structure. And I said, why are you doing that? And they're like, well, it's something we've been considering for a while. It's not because of the activist investor. And I said well, how long have you been thinking about this? And tell me what board discussions went on to move to the EPS structure.

And there was not much — we didn't really get a good answer back and in that sense. And the other thing they're noticing, for example, is some of these activist investors get a board seat. And on the other hand, they pledge almost the entire position that helped them get this board seat in margin accounts, creating different kinds of risks, and companies let them do that. So I think what we are trying to see is how do we, as long-term investors — we may not have a seat at the table, but how do we ensure that boards are taking care of our interests?

And they're putting guardrails, such as if you want the board seat, you [can't] pledge your position. Or if you want that board seat, you have to hold your position. If you drop your ownership to less than the 2%, 3%, you lose your board seat. Those are the kinds of guardrails that we, as long-term investors, need to start seeing. Again, I'm not saying all activists are bad. I'm just saying that these are certain issues we're seeing.

Kurt Schacht, CFA: What do you think about share buybacks? Generally speaking, is that a short-term-ism kind of focus by an activist, or do you look at those case by case?

Rakhi Kumar: We look at it case by case. There are companies who do it as part of the capital allocation strategy. They tell you up front, we're going to be putting this much in investing in the business. And I think what is troubling for us is, when you have an activist investor — there was nothing in the capital allocation strategy to buy back, and then suddenly you have buybacks. And guess what? EPS is now a driver in the pay, also. So you've completely aligned management to your strategy of buyback. So I think those are the kinds of situations where we are concerned about stock buybacks. But if it's part of your plan and it's a long time, I'm very comfortable with buybacks.

Kurt Schacht, CFA: So you've stepped up. I think there's other index investors that have stepped up, and they try to keep management accountable, either directly themselves or by supporting these activist initiatives out there. How might that — if they don't step up, if your ilk and other investors that are voting, for example, just voting routinely with the proxy advisers' advice — if they don't sort of step up and hold management accountable, what does that do to the quality of the indexes, maybe, number one? And number two, what do you think that it does, maybe, to the broader economy?

Rakhi Kumar: Yeah, I do feel that — so one thing's about not engaging. But there are asset owners. We're doing this — our clients are asking a lot about our asset stewardship programs. There is pressure from our clients to ensure that we are — some of these asset owners are the ones putting shareholder proposals. I don't put the shareholder proposal. But I may be supporting or evaluating my asset owner's shareholder proposal.

And guess what? They ask me every year — how did you vote on these proposals? It doesn't mean I want to support all of them because I want this one client, because I have — they're one of many clients that I have, thousands of clients that I have. But at the same time, there are mechanisms. You have the PRI, where you have to report on these aspects. And in the UK, for example, you have the likes of Towers Watson, Mercer, etcetera — some of the consultants who work with asset managers who actually evaluate your program and will give you a rating and ranking. And that feeds into the decisions made by the asset owners. So I think that you're starting to see that in Europe. Not quite so in the US, but that's maybe a sign of times.

Kurt Schacht, CFA: How much transparency is there around how you vote these proxies and how you vote both the case-by-case and routine things?

Rakhi Kumar: So, one of the things we try to do is we try to explain our framework — I think we're getting better at it — when we are taking big positions. Like I said, the climate paper's an example, the board leadership letter that Ron sent out, our CEO sent out, to thousands of company directors is an example, where we're making ourselves more transparent to make sure that companies know who we are as investors and what we want.

The other issue is, we've also enhanced our reporting on what we do. We also this year are putting out our vote record on an annual basis, where we're showing you how we voted and why we voted. Because we know we can substantiate every vote that we have done. And we also provide a list of all the companies. Last year we spoke to about 560-odd companies. And we gave you a list of all our companies that we engaged with. So we tried to enhance transparency that way.

Kurt Schacht, CFA: An audience question — does Canada still have the best corporate governance standards, internationally?

Rakhi Kumar: Yeah, so it's really interesting, because we spent a lot of time before the proxy season studying Canadian corporate governance, and I do have to say I was surprised. Part of the reason is because you have — it's like the federal system like you have in the US. You have the listing rules. And Quebec is very different. Then you have Toronto. You would want to be surprised that you don't require 100% independence on some of the key committees. And I was surprised to see what the numbers looked like. So our standards for Canada are much higher than the current regulation and requirement or even some of your proxy advisers'.

The other issue is the say-on-pay vote. It's not required here. Companies can decide to put it up if they want to put it up. And in that environment, it sets it up where we, as investors, are shooting — the company that wants to is actually giving us a voice to say. So it really puts us in a very difficult position. And I think Canada — I'm not saying governance is bad. I think governance is just practiced differently. And you really need to understand where we are and what we expect versus what the regulation requires from different jurisdiction to jurisdiction. And I think Australia's in the same boat, where the impression is that it's practiced very differently. But when you start scratching the surface and looking at policies, you're like wow, I didn't know it was like this, that it was practiced this way.

Kurt Schacht, CFA: You and I talked about this before. If you look 5, 10 years down the road here, there's going to be more assets under management coming into the passive strategies. Skilled active is still going to be a component, but its relative size in terms of the global assets under management is likely to be down pretty significantly. So you're going to be competing further in a world of larger and larger, bigger and bigger indexers. How do you compete? Do we compete on the basis of price, or is it service, or is it maybe the stewardship that we're talking about?

Rakhi Kumar: I think it's everything. It's not just one thing. We're all competing on everything. Like I said, it's very hard for me to predict. I think there is value in stewardship. And I think there are asset owners, and a growing number of asset owners, who recognize this value of stewardship. There are efforts underway in Europe to evaluate stewardship programs. But I think that in the end, every asset owner is going to look at a whole host of issues. And those who value asset stewardship are going to know how to evaluate it and may be willing to pay for it. But, of course, it's hard to say. I think we are going to have asset owners who say no, I want the cheapest product. And some are going to say no, I want a — and they're going to make different decisions.

Kurt Schacht, CFA: Do you worry about free riders? People that will say, well, State Street's got all of the resources in order to do this, so we'll just kind of let them engage. Maybe their costs go up a little bit, and we'll just sort of ride the coattails of State Street on this thing.

Rakhi Kumar: So if it's other passive investors, then there's a competitive advantage–disadvantage right there, because you will be eventually — if you're the only one in the market saying something which is resonating with your asset owners, then you're going to — so I think that the competitive forces will take care of that. Having said that, it may not be a bad thing for all of us to have different views. And so there are certain balancing forces. If all of us thought one way, it would be pretty dangerous place to live. So I think it's good to have different thoughts and views in the marketplace.

Kurt Schacht, CFA: How do you look at some of your developing markets, products, in terms of the ease of engaging and being a steward? There's lots of family control, lots of different cultural issues associated with public companies. How do you deal with that?

Rakhi Kumar: Right, so we tend to engage less on a country-to-country basis when it comes to emerging markets, primarily because as I said, there's no culture of engagement. But we engage, and we work with regulators in those markets to actually address the macro level or the issue that addresses across — that is applicable to all the companies listed in the market. Japan's a country which has now introduced a stewardship requirement. And that's interesting, because that market, the asset managers are still trying to understand how to do effective stewardship in a culture where you never questioned management in the past. So I think you're playing — the different things are playing out differently, but by and large, we tend to work with regulators and/or use our vote in emerging markets.

Kurt Schacht, CFA: So let me ask you this. If EPS is your least favorite metric, what is your favorite metric? Describe a well-designed compensation plan.

Rakhi Kumar: Yeah, so of well-designed — so it depends on the company, the sector. So if philosophically, if I were to step back and say, what is a good plan? You really want to understand what is the market looking at evaluating the company, to see performance, whether they're doing the right thing in the short term. The one-year performance is short term. But are those the right metrics to grow the business in the long term?

So if you think of stores, like the retail stores, same-store sales becomes an important issue. You could have growth, organic revenue growth in some businesses. You could have — and you're in a cost-cutting mode. Even margin issues are an example. And I think that is something that we look for. So in an ideal world, I would like to see the short-term drivers and the drivers of the company — and what we do is, we pull out investor decks. We don't pull out the corporate governance deck that they send. We pull out companies' investor data decks and see what they're constantly talking about.

And we want to see those metrics creep into short-term plans. On the long-term plans, we really want to understand how to ensure capital discipline, the balance sheet, and manage the balance sheet. So in those instances — and then performance. That means eventually, if you're getting everything right in the short term, it's going to show up in your performance or relative TSR against your peers if you have a relevant peer group — not against S&P 500, which is what a lot of companies do. I design products to be the S&P.

So you have to understand — you can then invest in SSGA product if that's the goal. But the point is that you really want to understand — or ROIC, if you're a heavy — if you're making investments, ROIC is a good metric. So I think we want to see a balance of metrics. We don't want to see too many metrics. It eventually does pay out. But there needs to be a tie up to the strategy and business for the companies talked about.

Kurt Schacht, CFA: I mentioned this to you, I was on a panel not too long ago with a couple of other big indexers. And the issue came up that while these firms claim to be good stewards, when you examine the proxy voting record, that they vote far more with management than with shareholders. What are your thoughts on that?

Rakhi Kumar: Yeah, so I think voting record is one way of analyzing us. I think it's very appropriate for when you're a small manager and you don't have access to management. But like I said, my asset stewardship program has two elements, the engagement element and the voting element. So when you think about it, for me, one could say that if I have access — you said I have access to directors. I have access to management.

For me, a vote against management is a — you could say a failed engagement, in some ways. And another thing to keep in mind is, as a passive investor, when you don't have the option to sell, I liken it to being in a marriage where divorce not being an option. And you could go and turn around in a relationship: "Say, honey, we have a problem. Let's talk about it and work this out." Or you could say, "You know what? It's your fault. And guess what I'm going to do?" And that's how it — you're setting your relationship up when you're in a passive investor.

So I think you really need to understand — I'm not saying that you have to support them 100%, but you would expect some variability. By and large, you would expect to see in a few years, if you're constantly voting and there's no change — I think for us, we do an outcome. So in our 2015 annual stewardship report which is going to come out, we talk about — we have a whole page on successes — companies we engaged on, issues we engaged on, and what changes they made. And I think the outcome-based approach is very important.

Kurt Schacht, CFA: You and I talked also about this notion of the stewardship movement and the model changing from one of shareholder primacy to a model that is more a stakeholder primacy. We talked about investing for value versus investing for values. What do you think of this latest…?

Rakhi Kumar: Yeah, I find it very interesting when companies say, oh, it's a stakeholder versus a shareholder mentality. And as a long-term investor, the stakeholder and shareholder — if you don't take care of your stakeholders, you are going to suffer in terms of your — as a shareholder. And I think that is something that is played out. Like when you think of the BP, Volkswagen, you see Chipotle — that is an example where you have had to take on responsibility of the stakeholder. If you had managed your stakeholder responsibilities, then your stockholder would not have gotten hurt.

So I really think in the long term — another example, let me give you a more clear example. Companies in cost-cutting mode sometimes move and start going into minimum wage or cutting full-time employees and going part-time. Yes, it has an immediate impact. You say you're going to have layoffs. It's going to show up in your stock price for the next one or two years. But what happens, if you are in a customer-based industry and you haven't planned right, you're going to have customer dissatisfaction.

You've seen this play out in the Wal-Mart case, the McDonald's case, where they've had to — Wal-Mart has had to spend tons of money trying to train their staff. Because this is a long-term erosion of the stock price, and coming back from that takes a long time and a lot of money. It may take even more money than you did initially. So I think that stakeholder–shareholder debate needs to be in the long term — actually, they merge. There's no debate, really.

Kurt Schacht, CFA: You know, there's lots of discussions in various jurisdictions around the world about regulation in this area, some sort of either regulatory guidance or even maybe a mandate in terms of more requirements about fund values and about making sure there's more documentation around the issues of stakeholders and so forth. What's the role of regulators in government and making more of a switch from a shareholder primacy to stakeholder primacy?

Rakhi Kumar: I think that if you're pushing for disclosure — I don't really know. The regulation that I see right now — and it's not really regulate — I mean, it's not regulation. It's a best practice, like the stewardship requirements in the UK. It's a compliant explain code, and I think that's the right way to go in terms of giving you the flexibility. Because as I said, you cannot have one expectation of all different kinds of investors.

If you force an asset stewardship program for an investor, and it's not suitable for their investment strategy or who they are as an investor, you're going to have disastrous consequences. You're going to have people voting for the sake of voting no, instead of voting for effective change, and those kinds of issues. So I think when it comes to regulation, I would say that it needs to be well thought out, and there needs to be enough flexibility to ensure that investors are doing what they're doing makes sense for them.

Kurt Schacht, CFA: Do you find it confusing — there's a number of different frameworks that are now bouncing around. There's the GRI, there's the integrated-reporting framework. There's a new SAS BI reporting framework for these sorts of issues. Is that confusing, in terms of what both the issuer and investor should expect? Or are they complementary? Or, what do you see?

Rakhi Kumar: So right now — and I would say that we definitely need consistency and identification of ESG risks and the methodology for calculating these risks. Because right now, if you want any kind of — if you want to do negative screens, you want to do integration on the front end, create products — if you don't have the data, you can't do anything. And sometimes we've had instances where we've had false positives. So we've had companies where they've — this is false negatives, sorry.

So we've had companies been screened on our ESG screen, and we engage with them and they actually do really well, but they don't disclose. So that's an example where — but we need something. So nobody's at the point where it's — everybody's still developing it, and I think that we support the development, the end product or the end objective, but I'm not sure we have a position on what's better.

Kurt Schacht, CFA: You know, we had at least a couple of decades now about how this whole corporate governance and ESG activity has evolved. Would you agree that what's happened in the last two decades, that officers and directors are much more attentive to these areas and being more accountable to shareholders? Have you sensed that in your career, that there's been more and more attention being paid to this in the corporate boardroom and with the officers and directors?

Rakhi Kumar: Yes. I think by and large, directors are more empowered today. They're probably more empowered today than they ever were, in the US at least. I think that reputational risk is the highest concern when it comes to ESG issues, particularly if they get a failsafe — that seems to be the biggest motivator for any board to talk to you. Having said that, I would say that you can tell different boards — with the quality of conversation, you have the accessibility, the approach to investors, and their responsiveness to investors in your conversations with them.

And I think in that sense, we see a whole host of issues where there'll be — sometimes I've had directors yell at me. And sometimes I [have] directors saying thanks. "Yes, we don't do it, but thank you very much. Give us some time." And I think that that will always exist, I think.

Kurt Schacht, CFA: What's your biggest challenge in your role? What issue, or are there things that the board still doesn't get? What are some of — what's the biggest outstanding accountability issue, as far as you're concerned?

Rakhi Kumar: I think — and here, it's more of an — I wouldn't say all do it. I think there are some companies who manage it very well. But sometimes it's the feeling of — what I find very challenging is that we engage often with management. And I'm not saying the CEO level, I'm talking about levels below the CEO. And the assumption we have is, this information we are providing will get back to boards. Maybe they do, but they get diluted. Because what they get eventually is, "We spoke to 10 of your investors and this is what happened."

And I think what we have found that when we talk to directors directly and we say that we have an issue — sometimes we've be talking for two years with a company management. And we get a director and we talk about something, and then next they'll be like, "Thank you very much. We didn't even know about this when we've been talking about it two years." I think that's the biggest challenge — when do you know that the management is passing on the message versus filtering the message or not passing it on? And I think that's the challenge.

Kurt Schacht, CFA: That is Rakhi Kumar from State Street Global Advisors. Thank you so much for being with us today.

Rakhi Kumar: Thank you. Thank you for having me.

[APPLAUSE]

