The complex and changing world of fiduciary duty

Neil Dwane | Global Strategist, Allianz Global Investors

> "I believe that every **right** implies a **responsibility**; every **opportunity**, an **obligation**; every **possession**, a **duty**"[1]
>
> – John D Rockefeller

Summary

- Investors have many rights which need to be defended and utilised to their benefit, and for which asset managers have the fiduciary responsibility to fulfil.
- Asset managers are obligated to meet the full and changing fiduciary duties of investors, providing the opportunity to add value financially and to make a difference environmentally and socially for all.
- Active asset managers must act responsibly to hold companies and their management to account for all aspects of strategy, business model and investment.
- Engagement with companies should combine all the traditional analytical skills of financial and industry analysis with a more diverse set of expertise in areas such as the environment, climate change, pollution, social and other complex governance issues. This engagement can only be consistently and globally fulfilled by active asset managers with substantial research and portfolio management resources, who meet company management regularly thereby creating more of an impact.

Introduction

Fiduciary duty is to provide the highest standard of care to the beneficiary of that service.

There is no one universal definition of "fiduciary duty". The meaning and the obligations associated with it range across countries and jurisdictions. This ambiguity can be illustrated through the simple comparison of the role of the investment consultant in the US to the UK. In the US, the Employee Retirement Income Security Act (ERISA) states that anyone who exercises discretion over the assets of an investment plan automatically owes a fiduciary duty. As such, not only do trustees owe a direct fiduciary duty, but the actual appointment of an asset manager is also a fiduciary function. Comparatively, UK law does not prescribe such fiduciary obligation which has resulted in some asset managers considering their investor relationships as having fiduciary characteristics, whereas others defining them as purely contractual. Regardless, fiduciary duty of a service provider is determined by a number of statutory, equitable and common law duties which at their core have the obligation to

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provide the highest standard of care to the beneficiary of that service.

This lack of universal definition means that the interpretation of "fiduciary duty" can evolve to encompass the values viewed as fundamental to today's society.

Of old, investors sought professional help and insight from asset managers to help manage their wealth whilst delivering risk-adjusted returns. Such a mandate prompted the move towards both benchmarking and specialist managers, and evolved to include the safe custody of those assets. ESG impacts were not, as yet, considered valuable by asset managers as there was insufficient analysis available linking ESG factors and financial performance or risk mitigation. As investment managers increasingly considered it their sole fiduciary duty to maximise short-term investment returns, the assessment and incorporation of ESG values were rendered irrelevant.

The 1984 English case of Cowan v Scargill[2] seemingly confirmed this narrow financial interpretation. The infamous case involved the trustees of UK based National Coal Board pension fund. Half of the trustee board sought to restrict the fund from investing in "energies which are in direct competition with coal" however, to do this would prevent the fund from maximising its returns potential. The remaining trustees sought legal proceedings claiming to limit investment through the consideration of any reason other than financial was in breach of their fiduciary duty. The resulting judgement was perceived to require that profit maximisation should be placed above all other considerations. For a number of years this misguided interpretation meant that the long-term value of many E,S and G issues were simply ignored by both trustees and investment managers.

Over time, the asset management industry evolved becoming more complex, with more choice and certainly more diversity, yet it maintained its perceived mandate to meet those fundamental financial investor needs above all else. Moreover, despite occasional bond and equity markets setbacks, wealth was successfully created and purchasing power protected during that time. That was until the last decade or so when a confluence of financial, economic and monetary events combined to stress investment returns, challenge investor horizons, re-assess the value proposition for asset managers and make investing seemingly more accessible and transparent through new information technologies.

The shock financial crisis of 2008 led to many of the assumptions, which underpinned a number of 20th century financial theories, relating to the efficiency of markets, to be challenged. Investment Managers were suddenly held to account for being blind sighted by short-term numbers and investment horizons. Societal values and investors' expectations were changing, and the industry and the corporations being invested in both needed to react accordingly. Investors began to expect more comprehensive risk analysis – of both known and unknown risks. Whilst new insights from the field of behavioural finance began to shed light on how asset managers make financial decisions, particularly in times of crisis. The interpretation of fiduciary duty, both in practice and at law, has widened greatly and is likely to widen further.

Right – Responsibility

Despite this widening of fiduciary duty, the historical conservative interpretation of fiduciary duty as narrowly interpreted in Cowan v Scargill, still seems to persist among certain legal advisers and investment consultants. There remains an antiquated viewpoint that fiduciary duty for an equity investment can be delivered simply through meeting a company and voting at its Annual General Meetings and that fixed income investing conversely requires only collecting the coupon!

The evolution of investing has changed globally from the 1980s onwards. It has become more transparent and professional and the requirements needed to fulfil one's responsibilities have exploded such that investors now expect their asset managers not only to meet with company management regularly, but also engage on social, environmental and other governance issues, which are often far removed from the cold financial and industry analysis performed within most investment processes. These additional responsibilities are more complicated, requiring experience and professional judgement, which cannot be simplified by computer or algorithm-analysis.

Indeed, Allianz Global Investors has not only evolved its own standards for representing its investments at annual general meetings (AGMs) and similar meetings, using its proxies to vote constructively, but has also created its own globally consistent standards of corporate behaviour for ESG and related responsibilities. As importantly, part of our principles has been to discuss and agree on an ongoing basis what is material to both the company and to AllianzGI as shareholders so that we are not caught up in unnecessary minutiae nor seen to be wasting company resources.

From a fixed income perspective, the emerging and growing segment of "green bonds" allow, for the first time, investors to find returns from specifically targeting green, environmental, anti-pollution type of investments. Green bonds are now expanding within Europe and Asia and offering similar returns and risk profiles to existing bond structures. Despite the election of President Trump and his apparent hostility to green initiatives, it remains clear that the global investor base still expects high uniform ESG standards to be upheld in investment management portfolios.

Investors have many rights which need to be defended and utilised to their benefit which asset managers have the fiduciary responsibility to fulfil.

Opportunity – Obligation

As investors have become more educated, sophisticated and demanding, so asset managers have been able to demonstrate their expertise, their different approaches and investment time horizons, creating a bewildering array of styles, approaches and methods to protect and enhance their investors' wealth.

Thanks to zero interest rates from the central banks around the world, returns have become harder to achieve and increasingly more marginal in absolute terms. The net-of-fee returns have become more important and more challenged by cheaper indexed and now ETF type funds.

Alongside the fiduciary duty to create performance at a reasonable price, and provide value for money, the investment industry has an obligation to "actively own" a company regardless of being an active or passive asset manager. Active ownership is an obligation to actively vote in company meetings, engage with company policies, and enable integration into company actions. This obligation applies to all fiduciary services to asset managers and yet it is moot how a computer trading and portfolio rebalancing program can engage dynamically, systematically and judgementally with the managements of their investments, the non-executives and occasionally their auditors or other advisers.

It is also important to engage upstream by implementing and collaborating with policy makers. Active ownership not only benefits the company through improved operating performance, profitability, risk aversion, efficiency and corporate performance, but it also benefits the investors by directly linking corporate performance to the long-term investment goals rather than focusing on short term corporate earnings expectations.

Asset managers are obligated to meet the full and changing fiduciary duties of our investors which provide them with the opportunity to add value financially and make a difference environmentally and socially for all.

Possession – Duty

As the investment industry evolves and modernises, so too has the need to offer factors such as outperformance over benchmarks, value for money and the continued safe custody of assets which often involve the analysis of factors such as ESG, management remuneration and best practice in diversity, employee retention and engagement.

Some asset managers and intermediaries continue to define their relationship with investors as purely contractual and often do not take social and environmental issues into consideration as such obligations are not always specified in asset management contracts. In fact, the independent think tank E3G recently published evidence stating that 33% of asset managers who are signatories of the UNPRI do not employ any dedicated ESG specialists. Further, the analysis also showed how 20% of companies only employed one such expert.[4] In fulfilling our more complex fiduciary duties, asset managers need plethora of resources including expertise outside mere fundamental financial analysis and more capacity to meet and constructively engage with company managements as owners, not traders. Increasingly too, many investors wish to possess the insights and information gleaned from these interactions so that they understand how well their wealth is being stewarded in both cold hard financial data as well as in ethical value terms.

Indexation and the fast growing "ETF-ication" (EFT- Exchange traded funds) of many equity benchmarks, with the consequent passivity of shareholders, can unfortunately lead to less shareholder oversight and engagement, which is the forerunner of excessive short-termism from the company managements (as well as ETF investors as they trade the beta of markets, finding no additional alpha return). They can also create significant misallocations of capital as investor monies pour into the winners at any cost and fail to re-allocate according to long-term corporate prospects and valuations.

Passive strategies are attempting to combat this through the creation of ETFs that use negative screening. This well-meaning idea results in troubling situation. To ensure the screening operates within a consistent and reliable framework, an external ratings agency must first score each company in the benchmark. The sheer volume of companies, depth of analysis and agency resource means that they can only provide a basic score and often miss the nuances and full extent of sustainability – particularly in SMID cap companies. Agencies are also reliant upon information provided and disclosed to them by the company itself. Considering that a substantial amount of ESG data is self-reported or not reported at all, this information can be inconsistent or immaterial, leading to a grey area on data accuracy. For this reason, most active managers will use the agency score as a basis which is then enhanced by their own rating resulting from on actual active engagement.

Indeed, it is interesting to discover that between 1989 and 2015 only 20% of listed S&P companies, per longboardfunds.com, produced all the collective returns. This means that 80% of companies owned within an indexed ETF were losers. Moreover, with corporate lives shortening rapidly, investors need to ensure that they are invested both in winners now and in the future.

Active asset managers must possess the resources and then execute their duties responsibly to hold companies and their managements to account for all aspects of strategy, business model and investment.

Conclusion

The concept of fiduciary management is evolving at time when responsibilities are shifting. For example, who is responsible for protecting the interests of members of defined contribution pensions? In these schemes, the pension provider does not have fiduciary or equivalent obligations to the beneficiary in the way that a trustee would in a trust-based scheme. Policy makers will need to determine what duties are owed by insurance companies, asset managers or sponsoring organizations (ie, employers).

With the rise in importance of ESG issues, the argument that asset managers should take no account of these factors has become less tenable. In contrast to the narrow interpretation of the 1984 case Cowan v Scargill, the landmark Freshfields report on fiduciary duty, published by the United Nations Environment Programme's Finance Initiative in 2005: "... it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight, bearing in mind that some important economic analysts and leading financial institutions are satisfied that a strong link between good ESG performance and good financial performance exists."

While trustees do not define necessarily the "best interests" of beneficiaries in relation to social and environmental issues, the report goes on to say that they must have regard not only for "the interests of those who are entitled to the income, but to the interests of those who will take in future." [5]

At Allianz Global Investors, our approach to ESG truly aligns with these conclusions. We believe that it is only through active and ongoing engagement, proxy voting and stewardship that we can best protect the interests of our clients today and in the future. Fiduciary duty is a responsibility for everyone in the investment industry, and now is the time for trustees, investment consultants and corporations to take action and consider how to incorporate ESG considerations in their investment decision-making processes. Indeed, some would argue, it is their fiduciary duty to do so.

1 John D. Rockefeller Jr. Credo displayed at Brown University Library, Providence, RI 02912, (401) 863-2165

2 This interpretation has since been challenged in a number of reports for example, UNEP FI (2005), Fairpensions (2011), Kay (2012)

3 Missing in Action – The lack of ESG capacity at leading investors; Florian Egli and Sam Maule (March 2017)

4 Lord Justice Cotton in Re Whiteley (1886) 33 Ch D 347 at 350. See paras 3.57 to 3.61

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Allianz Global Investors GmbH, UK Branch, 199 Bishopsgate, London, EC2M 3TY

Telephone: 020 3246 7000

www. allianzgi.co.uk

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