Davis Polk

Vanguard Investment Stewardship Report Highlights the Investor's Focus on the Major Components of ESG

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Vanguard's Investment Stewardship Report for the year ended June 2018 reinforces its commitment to the four pillars: board composition, executive compensation, risk and oversight, and governance structures.

First, the data. Vanguard engaged with 721 companies, a 63% increase from 2014. These companies represented $1.6 trillion, or 47%, of total fund equity assets under management. The fund voted on 168,786 proposals at 19,357 company meetings across the world. 76% of its equity fund assets under management are invested in the US, and 86% of the assets with which it engaged were US-based.

Independent directors were included in 40% of its engagements, and board composition and compensation were part of the discussions half the time. Engagements may be event-driven, with a focus on a ballot item, contentious vote, or company crisis. Conversations may instead be topic-driven, such as targeting companies with a record of longer-term underperformance coupled with gaps in corporate governance. Finally, engagements may be simply strategic, in order for Vanguard to better understand a company's long-term strategy and how governance practices align with that strategy. The stewardship report covered examples of the types of engagement they undertook.

Board composition. Vanguard voted in favor of 4 out of 9 gender diversity proposals. During engagement, one company said that trying to identify diverse candidates limited the candidate pool. Another stated that it did not believe gender diversity would enrich the board. Vanguard supported the proposal at both companies and each has since appointed a woman to its board.

Executive compensation. Vanguard's concerns at specific companies noted in the report included one company providing an extraordinary retention award to its CEO and another with an "unprecedented compensation package" that led the fund to become concerned that supporting the package could set a worrying precedent in acceptable CEO pay. In addition, "[s]uch a significant investment in a single person" raised questions about that company's succession plans. Other issues with compensation included a CEO who was paid significantly more than his peers, similar to much larger companies and weighted toward short-term incentive programs.

Risk and oversight. The key questions related to risk for Vanguard include: how do management and the board oversee risk; what type of risk reporting does the board receive; how does the board identify red flags and ensure that these matters are elevated; how does the board ensure it is hearing "independent external perspectives," not just management's views; and what steps does the board take to understand a company's business culture and ensure it reflects the company's stated values.

Environmental and social (E&S) issues play an important role under this particular pillar. The fund engaged with over 200 companies in carbon-intensive industries and ultimately supported 11 out of 76 environmental proposals, compared with 2 out of 92 in 2017. Overall, this past year Vanguard supported 7% of 162 E&S shareholder proposals, which may appear modest, but is a significant increase from supporting 1% of 213 proposals in 2017.

In evaluating shareholder proposals, Vanguard considers whether the disclosure is material and relevant to the company's long-term value; whether the company already has sufficient practices and disclosures in place; and which option better reflects a long-term perspective – the company's public commitments or the proposal's request.

By providing no-names examples of actual engagements on key topics, the report impliedly pointed out that every company's discussion of practices and proposals is viewed in the context of other companies, an important element to keep in mind. For example, the report noted Vanguard's engagement with two consumer companies that received similar shareholder proposals for enhanced sustainability reporting. The first company was "disappointingly dismissive" of the proposal, seeing no reason to offer investors more disclosure, and Vanguard supported that proposal. The second company gave the proposal "thoughtful consideration" and Vanguard voted against the proposal in favor of the company's recommendation.

Voting on proposals is only one piece of the puzzle. Vanguard views sustainability practices as part of risk oversight and is encouraged by "competent boards" that are "educating themselves on sustainability issues." The investor encourages boards to seek out third-party perspectives and information and not just rely on management, with an understanding of how to evaluate these issues and integrate sustainability risks. Vanguard also wants companies to provide "consistent, comparable, decision-useful" disclosure on sustainability risks.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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