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Ownership Engagement by Institutional Investors: The Matter of Ability and Willingness

Abstract

The notion of institutional investors is prevalent now a day partly because of their growing stake in markets globally and partly because of their ability as a professional intermediary to influence investee companies. The ability of institutional investors to influence is not determined by their shareholding, but it is the matter of their ability and willingness to engage with investee companies. OECD framed seven features with nineteen choices that in different combinations form an institutional investor's business model. By using this framework, this research paper is the primary attempt to develop taxonomy for ascertaining various degrees of ownership engagement among different categories of funds in Pakistan. Taking structured interviews from fund managers/portfolio managers as data collection method, this study establishes taxonomy in which different categories of funds show different degree of ownership engagement positioning between "no engagement" to "insider engagement".

Key Words: Corporate Governance, Ownership Engagement, Institutional Investors

1. Introduction

Institutional Investors (II) are just like "intermediary investors" having the responsibility of managing and investing other people's money. These intermediaries are legal entities rather than physical persons and can take any form ranging from a joint-stock company to limited liability partnership. These investors are not homogeneous because these are different with respect to involvement in ownership engagement. Institutional investors are considered essential players for being the holders of public equity, which emphasizes the need to understand what role they play as shareholder.

In recent times, the industry of asset and wealth management has observed substantial growth globally with respect to increase in the quantum of investable assets. The overall worth of these assets increased to 214.6 trillion US dollars at the end of 2016 and total Assets under Management amounted to 84.9 trillion US dollars, having a 39.6 % penetration rate. It is expected that by the end of 2020 total investable assets and asset under management would increase to $ 279.3 trillion US dollars and 111.2 trillion US dollars respectively (JCR-VIS Credit Rating Company Limited, 2018). Figure 1 indicates historical and anticipated growth trends.

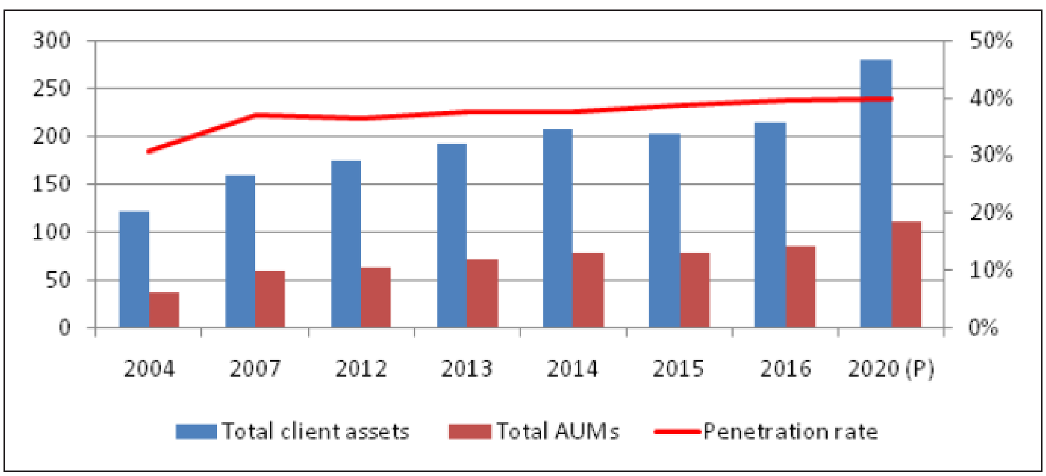

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***Figure 1*: Global Growth Trends adopted from Sector Update report issued by JCR-VIS**

When we talk about Pakistan, the asset management industry has also shown consistent growth, as an upward trend can be seen in investable assets and Assets under Management (See Figure 2). The local sector achieved growth rate of 11.8%[1] during the period 2013- 2017. Figure 2 depicts growth trend in assets under management (AUMs) of the local industry.

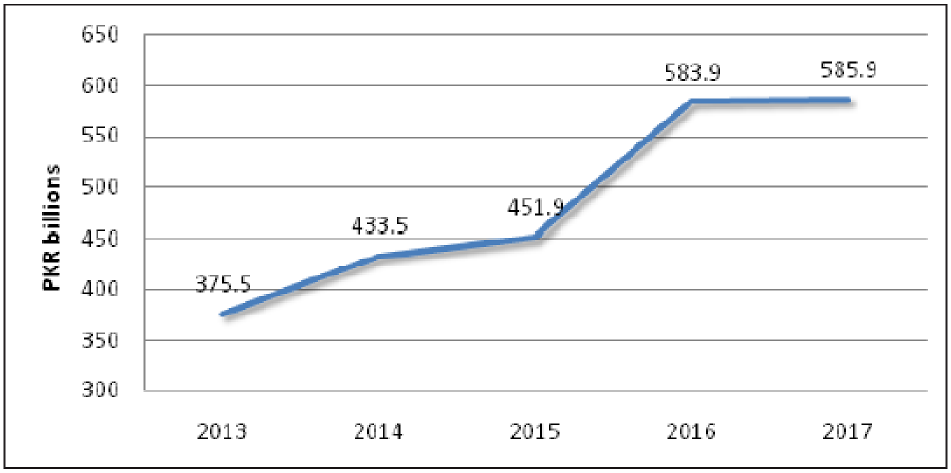

***Figure 2*: AUMs of Local Industry adopted from Sector Update report issued by JCR-VIS**

Despite all types of institutional investors that contributed in recent developments, this article refers to only fund industry because of availability of reliable data and this portion of asset management industry shows steady growth over a number of years. According to the report issued by SECP, the fund industry shows upward trend not only in terms of a number of funds but also from total assets under management. In 2018, 193different types of funds managed total assets of Rs.686.15 billion (SECP, Specialized Companies Division, 2018). Following graph shows the growth of funds in Pakistan.

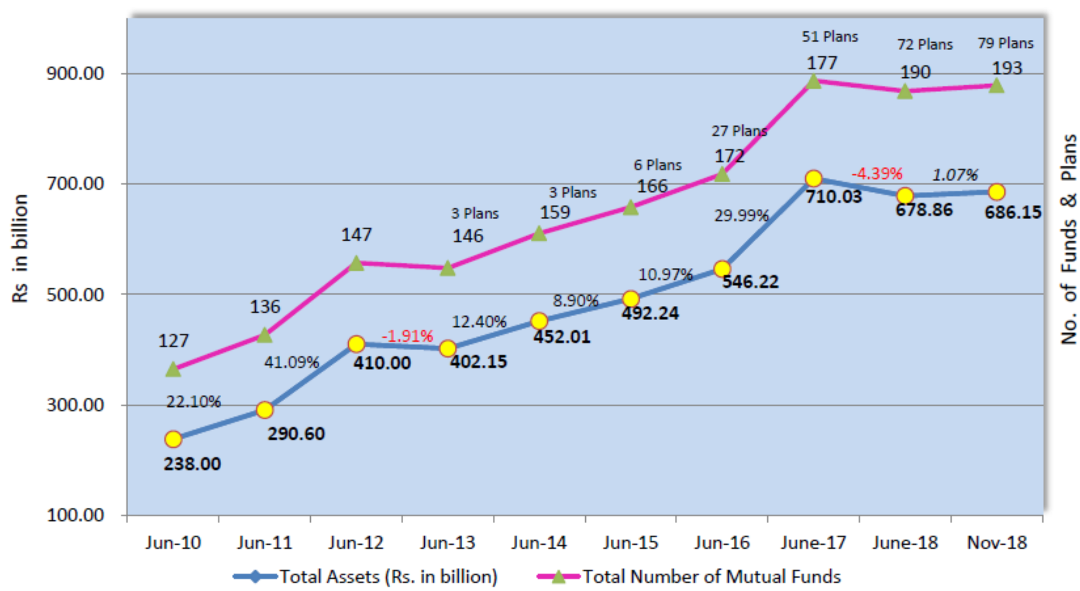

***Figure 3*: Growth of Funds in Pakistan adopted from the report issued by SECP**

[1] Asset management Company Sector Update issued by JCR-VIS Credit Rating Company limited on November 2018

In Pakistan, the patterns of shareholdings are changing slowly but surely now as Institutional Investors are becoming powerful investors (Khan & Nouman, 2017). The objective of this research is to gauge the ownership engagement of different categories of funds working as institutional investors in Pakistan. This study is unique of its kind that it explores the under research area of corporate governance, specifically in the domain of institutional investors.

2. Literature Review

The debate about the role of shareholders as owners is dominated by agency theory and stewardship theory (Davis, Schoorman, & Donaldson, 1997). Significance of ownership engagement is portrayed by Institutional theory which gives useful insight when we take shareholders as institutional investors and their role in promoting corporate governance. This part of the paper first clear the contrasting views of ownership, then cite some literature on ownership engagement and lastly give some insight into the Pakistani fund industry.

2.1 Metaphors of Ownership

The scholarly work on ownership has evolved from considering owners as just provider of capital towards acknowledging different metaphors of ownership grounded in sociology, psychology, management, law and corporate governance (Wang, 2014; Westphal & Zajac, 2013). According to agency theory, shareholders are the owners who provide capital to the company and possess certain rights after conferring control of assets to the management. This facet of ownership in which shareholders hold certain residual rights (Ownership as right) creates agency problem and criticizes by other theoretical findings (McNulty & Nordberg, 2016). Pierce et al. (2001) gave cognitive meaning to ownership as a commitment rather than just possessing some rights. To “own” something does not mean its possession only but it also tied with psychological association with the object. This aspect of ownership as commitment to company’s business gave rise to shareholder activism. Another contrasting view of owner is “Trader”. This is the most common way in which shareholders own the company. In large companies, shareholders switch in and out frequently, and capital markets ensure to make trading easier. In this ownership, shareholders are more concerned with making short term capital gains rather than using their fundamental rights in investee companies (McNulty & Nordberg, 2016). Monk and Minow (1995) developed a concept of “universal ownership” in contrast with ownership as a right, commitment and trading. According to this concept shareholder as owners has a fiduciary duty to monitor performance of company and influence Investee Company for the long term benefit to society. Lydenberg (2007) further elaborated the concept of long term engagement with Investee Company by picturing owners as “stewards”. Stewardship theory (Davis et al., 1997) posits that in order to work for the benefit of society in the long run, one should be willing to suppress his or her interests and act pro-socially. UK Stewardship Code (FRC, 2010; revised 2012) is a great move to encourage ownership engagement with companies.

2.2 Ownership Engagement

Ownership Engagement is not an obligation, nor a moral issue. But what is important is the role that ownership engagement plays to improve the governance of the corporate sector and benefit the society at large (Belinga & Segrestin, 2018). A good economy needs those shareholders that are having self-interest to allocate their funds in the corporate sector and then monitor these institutions to ensure best utilization of their funds. In order to fulfill this objective, shareholders are required to gather information about company’s prospects and utilize this information to involve with the institution and influence important matters like institution’s strategy, board composition, dividend policy etc. (McNulty & Nordberg, 2016). When shareholders engage with the institution, they perform a function which is vital for value creation and economic growth. This function provides a legal entitlement of various rights to shareholders, including access to the information, share transfer, involvement in decision making concerning vital organizational changes and Board elections. There are various costs connected with the exercise of these legal rights, which some shareholders are ready to bear, and some don’t want to follow (Isaksson & Celik, 2014).

In this paper, we discuss various aspects of mutual funds that affect the degree of ownership engagement. However, in order to forecast, or influence, the degree of ownership engagement between various categories of mutual funds, we have to emphasis on specific aspects of the fund’s business structure that shapes the inducements for OE. These aspects consist of various features, including the purpose of the company, their regulatory framework, liability structure, etc. this article will explain how these aspects differ, between different categories of mutual funds. For this purpose, the author uses seven critical aspects of a company’s business structure drafted by OECD with various choices and regulatory settings, which govern the character and degree of their OE. The following table shows different features and determinants of ownership engagement. Detail of these features and choices is given in the next section.

Table 1: Factors of Ownership Engagement

Purpose of Institution	Liability structure	Investment Strategy	Portfolio structure	Fee Structure	Political/Social Objective	Regulatory Framework
Profit	Short Term	1. Active Fundamental 2. Active Quantitative	Diversified	Zero Fee	No political and social incentive	No legal requirement
Not for profit	Long Term	3. Passive Index 4. Passive fundamental	Concentrated	Performance Fee Flat Fee	Political and social incentive	Engagement Requirement Engagement limitation

Note: Adopted from OECD

Categories of Mutual Funds

The following table indicates the classification of investment schemes as per categorization provided by SECP.

Table 2: Classification of Investment Schemes

Category	Investment avenue	Risk level	Regulatory requirement
Equity Fund	Equities, e.g. Stocks/shares	Riskiest	Must invest not less than 70% of total assets in listed shares.
Income Fund	TFCs, government securities like T-bills/ PIBs, or preference shares.	Moderate risk (Less risky than equity fund)	Must maintain at least 25% of assets in liquid form.
Money Market Fund	Treasury bills and bank deposits.	Least risky	-
Balanced Fund	Stocks as well as in debt instruments.	Moderate to high	Must allocate 30% to 70% of total assets in listed shares.
Fund of Funds	Other mutual funds like equity, balanced, fixed income and money market funds.	Risk based on categories of funds included	-
Sharia Compliant (Islamic) Funds	Shares, Sukuk, Ijarasukuks etc.	Risk based on category of fund	-
Asset Allocation Fund	Multiple types of securities	Highly risky	-
Capital Protected Fund	In this type of scheme, the payment of original investment is guaranteed with any further capital gain which may accrue at the end of the contractual term of the Fund.	Less risky	-
Index Tracker Fund	Securities mirroring KSE 100 index etc.	More risky	At least 85% of assets must place in securities of selected index.
Aggressive Fixed Income Scheme	Fixed income securities along with taking exposure in medium to lower quality of assets also.	Moderate risk	Must keep at least 10% in liquid form.
Commodity Fund	They invest at least 70%of their assets in commodity futures contracts	Risky	Must invest at least 70% of assets in commodity contracts.

Source: Information is booked from Securities and Exchange Commission of Pakistan (SECP)

Among all categories of funds, 82.033% of all assets under management are held by Equity fund, Income fund and Money Market fund and remaining 17.9% is managed by all other categories (SECP, Specialized Companies Division, 2018).

3. Methodology

Ownership engagement of institutional investors is difficult to observe and often take place behind the scenes (McCahery, Sautner, & Stark, 2016). Due to exploratory in nature, the most appropriate way to ascertain the level of engagement is interviews served as a qualitative research methodology.

3.1 Data Collection

Semi-Structured interviews are used as the data collection method. Total of 25 interviews were fixed from all categories of mutual funds and pension funds operating in Pakistan. These face to face interviews were 30 to 45 minutes long and digitally recorded. This sample of 25 interviews represents at least two interviews from each category of mutual fund and two interviews from pension fund. The interview guide is developed in light of the framework given by OECD in order to determine the level of engagement. Following part provides details on seven features with different choices used as determinants of ownership engagement along with different levels of ownership engagement.

3.2 Determinants of Ownership Engagement

3.2.1 Purpose

Obligation or no obligation to the beneficiary for profit maximization is the factor that differentiates various funds. For instance, shareholders of a pension fund usually don’t have expectations of return on their investment. On the other, income funds, equity funds etc. have the sole focus of profit maximization and their shareholders have high expectations of returns on their investment. So, this distinction between institutional investors is a determinant of ownership engagement (Isaksson & Celik, 2014).

3.2.2 Liability Structure

Choice of liabilities is a vital part of a fund’s business structure. For instance, funds, like voluntary pension schemes, specialize in long-term obligations, on the other hand, funds like mutual funds have either undefined or short-term commitments (Mcnulty & Nordberg, 2016). An institution can match its portfolio liquidity by accurately calculating the maturity of their investment plan in the case of long-term obligatory funds, i.e. pension funds. On the other hand, in the case of mutual funds, an institution is usually required a completely liquid portfolio because investors can exit at any time with giving any prior notice or warning. The liquidity structure may, in some cases be a hurdle to the ownership engagement (Isaksson & Celik, 2014).

3.2.3 Investment Strategy

In principle, an investment strategy is absolutely subjective. OECD has provided four key strategies which are not only related to various business mechanisms but are also significant for institutional investor’s role as owners (Isaksson & Celik, 2014). These strategies are named as “Passive Index”, “Passive Fundamental”, “Active Fundamental” and “Active Quantitative”.

“Passive index” is actually an important strategy which leads to the commitment of holding a portfolio which imitates a predefined index of shares. Development of index can be carried out in various ways, but its structure is already demarcated. Any change in the portfolio cannot be referred to as active mechanism, but it is the result of deviation in the underlying index. “Passive fundamental” strategy leads the investors to initially make a selection for the companies in which they are to invest and then keep the investment for a prolonged period.

The “active fundamental” approach is supposed to demonstrate a business mechanism where an investor relies on constantly selling and buying the shares of those institutions which are selected on the basis of fundamental analysis. “Active quantitative” strategy is characterized by processing a large amount of data on high-frequency trading by sophisticated software and utilizes such information while taking an investment decision (Isaksson & Celik, 2014).

3.2.4 Portfolio Structure

Portfolio structure is another determinant of ownership engagement as it directly relates to the cost of monitoring companies. Portfolio structures can be seen in two forms: concentrated or diversified. Concentrated portfolios mean holding few companies and it cost less to look after a handful. The diversified portfolio usually holds small stakes in many companies in order to mitigate risk of loss and repudiate from ownership engagement due to high cost of monitoring a large number of companies in portfolio (Isaksson & Celik, 2014).

3.2.5 Fee Structure

The fee structure is related to the degree of ownership engagement as it includes the cost associated with active engagement (Isaksson & Celik, 2014). There are three types of fee: Flat fee, performance fee, and hybrid, which is the combination of two. Flat fee is fixed, which is charged for managing the portfolio. Whereas, performance-based fee include a certain percentage over and above the fee for managing the portfolio and charged from the client when fund manager performs over and above the benchmark.

3.2.6 Social and Political Objective

For organization having the motive of profit maximization, there is no prior rationale to utilize social and political objectives as determining factor of ownership engagement. However, business structure, product and marketing distinction policy of an organization determines the extent to which the organization aligns its ownership engagement with social and political objectives. Mutual funds can be considered an example for this, as these funds attract those investors who don't intend to hold the stocks of certain organizations irrespective of the returns. Non-profit organizations, like pension funds, may have social and political concerns that may give a reason for their engagement (Isaksson & Celik, 2014).

3.2.7 Regulatory Framework

According to company law, Individual investors are not required to have any particular degree of ownership engagement; however, in some jurisdictions, they have to comply with certain regulations. For example, in USA Organizations under the ERISA Act are usually bound to vote. Similarly, in the United Kingdom, the Stewardship Code also emphasizes the use of voting rights by the Shareholders (Ivanova, 2017). On the other hand, in Sweden, it is legally prohibited for Swedish pension fund to use voting rights as shareholders. Similarly, in Turkey, the mutual funds are not legally allowed to participate in the governance of the investee companies (Isaksson & Celik, 2014). In Pakistan, the regulatory framework give voting rights to all types of funds, and it is obligatory for mutual funds and asset management companies to disclose voting policies.

3.3 Levels of Ownership Engagement

Ownership Engagement is a matter of ability and willingness to play an active role as owners. In order to determine the level of engagement, OECD framed certain features with some choices for those institutions where regulatory restrictions are not available. Different organizations follow different degrees or levels of engagement. OECD has provided four degrees of engagement which ranges from zero engagement to inside engagement (Isaksson & Celik, 2014).

The purpose of this article is to determine the level of ownership engagement that is the logical consequence of the choice of determinants made by different categories of funds. Brief description of four levels of ownership engagement is depicted below.

3.3.1 No Engagement

This degree comprises of those organizations that don't monitor individual investee companies actively. Neither they use their voting rights as shareholders, nor are they engaged with investee companies. Turkish mutual funds are an example of no engagement (Wong, 2010).

3.3.2 Reactive Engagement

This level of ownership engagement refers to exercising voting rights based on pre-determined criteria (Belinga & Segrestin, 2018). At this level, institutions somehow engaged with investee companies depending upon guidance given by proxy advisors.

3.3.3 Alpha Engagement

Alpha engagement is that level where institutions or funds pursue to perform above benchmark by utilizing diverse tactics (Isaksson & Celik, 2014). When institutions want to beat market standards, they actively monitor their investee companies and take decisions accordingly.

3.3.4 Inside Engagement

This engagement level is the final degree of ownership engagement. It is characterized by using voting rights, vital corporate analysis, and sometimes having a seat on board. Shareholders at an inside level usually hold significant stocks with controlling rights (Isaksson & Celik, 2014).

3.4 Data Analysis

Using this framework drafted by OECD, this research paper explores the engagement level of the fund industry in Pakistan. For this purpose, structured interviews are conducted from different categories of mutual funds and pension funds. Members of investment committee or fund managers/portfolio managers are the appropriate individuals in each category of fund which can provide the best information in this regard. Descriptive analysis is conducted to get the results. The following section provides detailed findings of the study accompanied by discussion.

4. Findings and Discussion

4.1 Corporate Governance Taxonomy of Funds

It becomes evident that ownership engagement plays a vital role in society by the efficient apportionment of capital and the monitoring of Investee Company's performance in order to enhance corporate governance. But in reality, it is also observed that some shareholders are not willing to bear the cost of carrying out this task purely on rational grounds (Isaksson & Celik, 2014). Ownership engagement is purely the matter of ability and willingness to play active role in promoting corporate governance positively. OECD frame certain features and choices that together determine the level of ownership engagement among different institutional investors.

This study is the primary attempt to use that framework in order to ascertain the engagement level among different categories of funds functioning as institutions in Pakistan. Figure 4 characterized different categories of funds showing their level of engagement as per the criteria of seven different features and choices given by OECD.

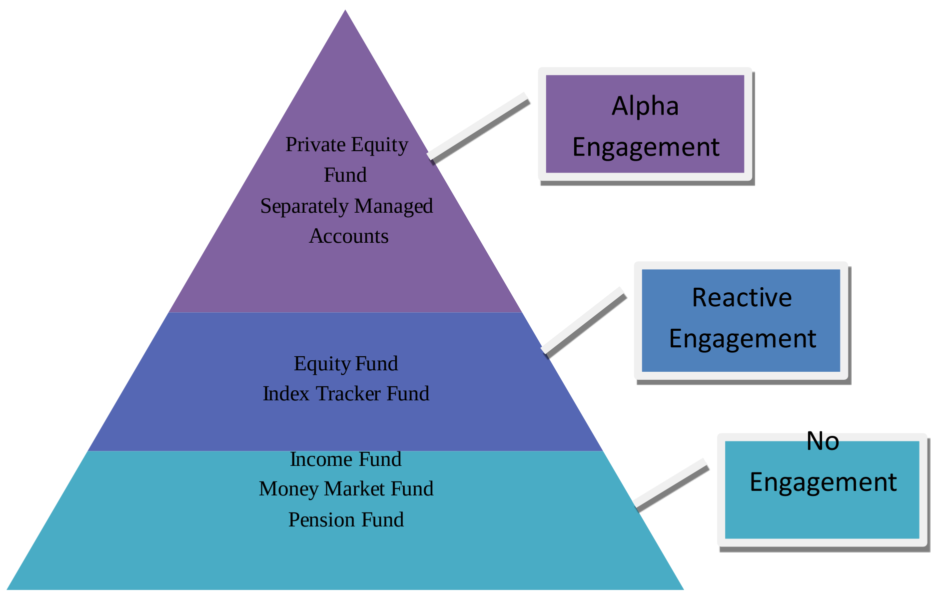

Figure 4: Corporate Governance Taxonomy of Funds Industry

4.2 Discussion

Income fund, money market fund and pension fund fall under the category of "no engagement". Income fund and money market fund both are for-profit with short term liability, diversified portfolio, flat fee structure and no political or social incentives. The objective of pension fund is not to earn profit but to facilitate employees with a smooth stream of earnings after retirement. In Pakistan, pension system prevails mostly in the public sector including government and semi-government institutions. The study found that government directly or indirectly exerts some influence in public pension funds. In order to facilitate individuals, SECP launches Voluntary Pension System (VPS) under which any adult, having CNIC can contribute during their working life and pension fund provides regular income after retirement. This pension fund works on individual pension account invested for the long term. These funds usually do not actively engage as owners not because they are incapable as institutional investors but because they are not willing to bear the cost of being active owners. They chose to be a provider of capital only instead of being active monitors of investee companies.

For reactive engagement level, the two categories include Equity Fund and Index Tracker Fund. Both funds share the same features as having a diversified portfolio, flat fee structure, with no political and social influence, and no regulatory requirement also profit at the top. But they differ in investment strategy and liability structure. An equity fund is the riskiest fund with the objective of long term growth. These funds invest in portfolio of stocks. According to SECP, it is obligatory for equity fund to invest at least 70% in listed securities. They usually opt for active fundamental investment strategy that brings these funds in the category of reactive engagement. On the other hand, Index Tracker fund invests in securities to mirror a market index like KSE 100. The fund's performance tracks the underlying index's performance. They have a passive index investment strategy because they usually mimic the predefined index. The fund contains the right to exercise their voting power that categorizes these funds under reactive engagement.

Private Equity fund and Separately Manage Accounts (SMA) are only two categories that fall under the taxonomy of alpha engagement. Both categories are for-profit with short term liability, performance-based fee structure, with no political and social incentives to engage and no regulatory requirements. Private equity fund has active fundamental investment strategy characterized as continuous buying and selling of stock and having an eagle eye on the performance of Investee Company whereas SMA has passive fundamental investment strategy characterized with acquiring the information about the company and using this information while making an investment decision. Without any regulatory bindings, both categories of funds exercise a high degree of ownership engagement.

It is worth mentioning that among several categories of funds, no single fund fall at the level of "Inside Engagement" characterized by having controlling or significant stakes in listed companies. One possible reason behind the lack of inside engagement is that all kinds of funds mainly focus on returns and do not structure to get control over investee companies. Almost all participants of the study agree that our financial markets are not resourceful that process information efficiently. We do not have sophisticated systems that process large inflows of information; thus, not a single fund reported an active fundamental investment strategy.

The purpose of this taxonomy is to understand the different levels of engagement prevail in the fund industry of Pakistan using a framework adapted from OECD. There may be other determinants and choices that can be included or excluded in this framework, and one can form endless combinations. This exploratory work opens different avenues for researchers to further investigate this under the research area.

5. Conclusion

The ownership structure is under a dramatic change from individual investors to institutional investors. Institutional Investors (II) are organizations that collect money from individuals and companies in order to make an investment in portfolio companies and yield returns (Mcnulty & Nordberg, 2016.; Monk & Minow, 1995.; Lydenberg, 2014). Owing their professional capabilities, the public has confidence in them. Professionalism and large shareholdings make them an effective monitor that can have better say and influence in corporate strategy (Freeman & Reed, 2010). Throughout recent decades, the remarkable growth of II attracts communal attention. Their involvement in various parts of the economy makes these institutions crucial to study with an objective to gauge the influence. II can engage with investee companies, observe their management, swap assets with significant penalties on the value of shares and resultantly impact the economy on the whole (Schmidt & Fahlenbrach, 2017).In Pakistan, the patterns of shareholdings are changing slowly but surely now as II are becoming powerful investors (Khan & Nouman, 2017). This research is the primary attempt to gauge the ownership engagement of different categories of funds working as institutional investors in Pakistan.

The increase in institutional ownership globally and locally is subject to regulatory measures in forms of voluntary codes and regulations. The most recent example is the "UK Stewardship Code" specially designed for institutional investors (Ivanova, 2017). These regulatory frameworks provide these institutions with several rights that help them to perform active part as owners. In reality, it is observed that not all institutions play a significant role in promoting corporate governance as owners. The role of these institutions is limited to serve their clients solely. Ownership engagement is not associated with a number of shareholdings and exercising voting rights. But it is the matter of ability and willingness to actively play a role as owners while monitoring investee companies. OECD determine different features with choices, of institutional investors that in different combinations make a taxonomy that categorizes these into different levels of ownership engagement (Isaksson & Celik, 2014). These features include the purpose of institution, liability structure, investment strategy, fee structure, political and social incentives, and regulatory requirement. Using the framework developed by OECD, this research is the pioneering attempt to make a taxonomy of different categories of funds operating as institutional investors in Pakistan. The most dominant part of institutional investors in Pakistan is mutual funds and pension funds. After conducting structured interviews from fund managers/portfolio managers, this study found that private equity and separately managed accounts are two categories fall under "alpha engagement" characterized as active owners who monitors and exert influence on investee companies. Equity fund and Index tracker fund can be categorized as "reactive engagement". Other funds like money market fund, income fund and pension funds do not engage with investee companies and hence fall under the category of "no engagement". This study also found that in Pakistan fund industry, no institution falls under the category of "Insider engagement" characterized with controlling rights through seats on boards. This taxonomy of different categories of funds in Pakistan is helpful in understanding the role of institutional investors as owners in promoting good corporate governance.

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