

Institutional investors as stewards of the corporation: Exploring the challenges to the monitoring hypothesis

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Abstract

The study explores the challenges UK-based institutional investors face when trying to monitor investee companies and influence their social, environmental, and governance practices. Consistent with previous research, I find that misalignment of interests within the investment chain and dispersed ownership are factors which inhibit investor activism. However, other underexplored challenges include lack of investee company transparency and investor experience in activism, as well as low client demand for engagement and internal conflicts of interest. The results contribute to the literature on institutional investor activism by using direct empirical evidence to systematically discuss the challenges to stewardship. Given the intensification of media and regulatory attention on shareholders in the post-global financial crisis era, coupled with investors' growing awareness and practice of stewardship, the research opens new avenues for enquiry which go beyond the on-going debate about the monitoring versus short-termism roles of institutional investors.

1 | INTRODUCTION

The global financial crisis of 2008 has given a new impetus toward rethinking the fundamental principles of corporate governance. It is now widely accepted that one of the causes of the downturn can be attributed to institutional investors' failure to monitor their investee companies. The Walker Review, commissioned by the UK government to investigate corporate governance standards of UK financial institutions following the banking crisis, concluded that risky business models went unchallenged by major investors in the pursuit of short-term gains to the detriment of the economy (Walker, 2009).

In a recent study, Manconi, Massa, and Yasuda (2012) find evidence that the portfolio decisions made by liquidity-constrained investors contributed to the spread of the crisis from the securitized to the corporate bond market. The economic recession, alongside recent controversies around tax avoidance and fossil fuels, have highlighted the need for more active monitoring by institutional investors (comprised of banks, pension funds, insurance companies, and other bodies that trade in large share quantities and invest money on behalf of shareholders). A number of UK government reviews (for example, Kay,

2012; Myners, 2001) put an emphasis on the responsibility of investors to act as "stewards" of the companies they hold shares in, which entails "holding the board to account for the fulfilment of its responsibilities" (Financial Reporting Council, 2012, p. 1).

The literature on institutional investors is dominated by a debate concerning their role and behavior. Two opposing views exist, which are labeled by Callen and Fang (2013) as "monitoring" and "short-termism." The monitoring perspective suggests that institutional investors are focused on maximizing long-term value, as opposed to generating short-term profits, and they engage with management in order to achieve this objective (Dobrzynski 1993; Monks & Minow 1995; Shleifer & Vishny 1986, 1997). Previous research provides evidence of the positive effects that institutional ownership has on: CEO turnover (Helwege, Intintoli, & Zhang, 2012), research and development spending (David, Hitt, & Gimeno, 2001), firm performance (Elyasiani & Jia, 2008), corporate governance (Aggarwal, Erel, Ferreira, & Matos, 2011), executive compensation (Janakiraman, Radhakrishnan, & Tsang, 2010; Zheng, 2010), and market wide negative shocks (Cella, Ellul, & Giannetti, 2013). Empirical evidence consistent with the monitoring view also reveals that institutional shareholder activism results in improved firm

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operating performance and profitability (Dimson, Karakas, & Li, 2015), increased shareholder value (Becht, Franks, Mayer, & Rossi, 2010) and positive market reaction for the target firm (Cunat, Gine, & Guadalupe, 2012; Klein & Zur, 2009).

However, there are researchers who argue that investors do not engage with investee companies enough (Black, 1990), preferring to, in cases when monitoring is costly or time consuming, respond to a poor performance by just selling their shares (Coffee, 1991; Manconi et al., 2012). Ivanova (2016) explores some of the reasons why this trend is more pronounced in the UK than in the United States. Davis (2008) and Jackson (2008) observe an ownership paradox related to shareholders, whereby large institutions have traditionally adopted a passive approach and have refrained from challenging management's decisions. The short-termism perspective sees institutional investors as transient owners (Bushee, 2001), who have high turnover portfolios, are focused on short-term performance, and fail to act as responsible stewards of the corporation (Graves & Waddock, 1990; Yan & Zhang, 2009).

Over the last two and a half decades institutional investors, with their global diversified portfolios, have emerged as an influential actor in the capital markets (Wen, 2009) and have come to be regarded by some as a crucial driver of improved CSR performance across companies: "it is institutional investors (...) that are most likely to provide leverage on companies to improve their performance with respect to CSR" (Sparkes & Cowton, 2004, p. 54). As mentioned above, the importance of institutional investor stewardship for good corporate governance has been emphasized by the UK government, and the positive effect of monitoring has been well documented in the empirical literature. In addition, the public and the media have exhibited an increasing awareness of business ethics (Wen, 2009). Research conducted by Aguilera, Williams, Conley, and Rupp (2006) reveals that, compared with the United States, topics such as corporations and investors' social responsibility are more frequently discussed in the UK media.

The purpose of this study is to contribute to the monitoring versus short-term debate in the literature by going beyond what has traditionally been the focus of research enquiry. Previous studies have so far attempted to predict the effects of investor characteristics on the willingness to intervene and have tested the relationship between monitoring and different variables such as firm value, R&D, and executive compensation. However, another crucial question has been strangely neglected, given the rising emphasis governments, the media and the public have placed on prudent institutional ownership behavior. This overlooked question is "What are the challenges faced by active investors who are concerned about environmental, social, and governance (ESG) issues and who monitor corporate management to improve firm performance?" Understanding such challenges would be of relevance to researchers studying the behavior of institutional investors, as well as actors who endeavor to incite greater investor activism. Leaving the issue of passivity among shareholders aside, the main focus here is not on explaining the reasons for this passivity, but on understanding the challenges faced by engaged investors who endeavor to exercise control over investee companies. As such, factors such as short-term investment horizons, preference for exit over voice, and lack of univer-

sal belief in the link between monitoring and firm performance will not form part of the discussion. Here, the terms monitoring, shareholder/investor activism, and active ownership are used interchangeably to denote the same activities related to "the use of ownership rights attached to ordinary shares to influence company management" (Sparkes, 2008). These activities encompass not only shareholder voting at annual general meetings (AGMs) and filing of shareholder resolutions (Sparkes, 2001), but also informal dialogue (or engagement) with corporate executives (Sparkes & Cowton, 2004), asking questions at an AGM, letter writing and publicity campaigns. In reality, monitoring and shareholder activism do not rely on a single strategy, but often involve a combination of key activities (see Ivanova, 2016). Therefore, the definition used in the study comprises investor actions that involve both private dialogue and public confrontation.

The findings are based on a detailed empirical investigation encompassing semi-structured interviews with institutional investors, socially responsible investment (SRI¹) experts, and NGOs which engage with investors with the aim of inciting active monitoring behavior. Direct knowledge on the interactions between companies and investors, and the challenges faced by the latter, is scarce as engagement often takes place behind closed doors (Becht et al., 2010; Owen, Kirchmaier, & Grant, 2006). Even when present, discussions about the barriers faced by active owners are of a supplementary nature to the main research enquiry, the findings are speculative (Wen, 2009), based on quantitative survey data (McCahery, Sautner, & Starks, 2016), or focusing on only one activist institution (Becht et al., 2010; Carleton, Nelson, & Weisbach, 1998; Smith, 1996). The current paper helps to fill this knowledge gap by conducting a qualitative study centred on a question which it is hoped will open new research pathways within the monitoring versus short-termism debate. By not focusing on a particular case study, and instead eliciting the views of a wide range of investors, SRI professionals and other stakeholders (i.e., NGOs), the paper provides a more generalizable perspective of the challenges faced by active owners.

The study researches UK-based institutional investors since the UK has the strongest tradition of active ownership in all European countries and is recognized as a leader (Louche & Lydenberg, 2006), with the highest number of shareholder activist campaigns outside North America (Khorana, Hoover, Shivdasani, Sigurdsson, & Zhang, 2013). Shareholder activism is very context-specific, with factors such as the corporate governance system and regulatory environment of a given country having an impact on engagement dynamics. Therefore, limiting the geographical scope to institutions with headquarters in the UK enables a more in-depth exploration of the challenges to engagement in this particular context, by limiting complexity. The current paper also addresses an imbalance in the literature related to the higher quantity of studies exploring the phenomenon from a U.S. perspective. The generalization of findings beyond the UK is impeded by the context-specific nature of the phenomenon under study, but the results discussed here could be of use to other scholars in the future, who wish to make a comparison with empirical findings they have obtained in a different geographical context.

This paper makes several contributions to the field of SRI from a theoretical, empirical, and practical standpoint. First, the research provides direct empirical and qualitative evidence of institutional investors' perceptions of the impediments to stewardship. Second, in a recent special issue of *Business Ethics: A European Review*, Campbell and Cowton (2015, p. 5) ask: "Why is it of interest, for example, if two particular variables are correlated?" and "If ethics does not pay, so what?" In response to this, the study goes beyond what has traditionally been the focus of research enquiry—the correlation between different variables—and contributes to the monitoring versus short-term debate in the literature by expanding the remit of research questions. Third, I contribute to the work of Juravle and Lewis (2008) who created a framework identifying impediments to responsible investment (RI) on three levels: institutional, organizational, and individual, by providing empirical evidence for the existence of some of these challenges and by expanding the framework through discussing impediments not previously observed in the literature. Fourth, the study offers a broader perspective on challenges to action across different types of investors, thus expanding Sievanen's (2014) work which has a specific focus on pension funds. Moreover, the study has practical implications as it provides information which could aid policy makers in designing incentives for RI. The insights generated here could also be of value to various stakeholders engaging with investors such as unions and NGOs.

The empirical results reveal that the five main barriers that inhibit institutional investor monitoring of the corporation are: misalignment of interests within the investment chain; poor company transparency on ESG issues and lack of investor experience in shareholder activism; internal conflicts of interest; diversified portfolios and resource scarcity; and client inertia. The paper is organized as follows. Section 2 explores the rise and growing significance of institutional investor ownership and activism. Section 3 reviews prior literature on the propensity of institutional investors to act as monitors and the effects of monitoring behavior. Section 4 describes the research methods, sample and data analysis technique. Section 5 presents the main empirical findings. Section 6 outlines the implications of the research and concludes.

2 | INSTITUTIONAL OWNERSHIP AND ACTIVISM—RISE AND SIGNIFICANCE

Until the early 1960s, individuals dominated the activist landscape in the UK as they held close to 55% of all the shares (Office for National Statistics, 2012, see Figure 1). This trend has changed drastically as individuals now hold 10.7% of UK equities. Figure 1 shows that, from the 1960s onward, institutional investors substantially increased their equity exposure. Historically, the ownership structure of the U.S. stock market has developed following similar trends (see Gillan & Starks, 2007). More recently, as a result of globalization, UK equities held by foreign institutions have increased sharply post-1994 and they are currently at the top of the list, holding 53.2% of the equity market as of 2012.

At a more granular level, Table 1 explores the historical stock market ownership patterns of some of the biggest institutional investors such as pension funds and insurance companies.

By the 1990s pension funds and insurance companies were the most prominent holders of equity, accounting for more than half of the total (see Table 1). Although their ownership stake in the market has decreased, they still hold a significant proportion of shares (11% of the value of the UK stock market, Table 1). Furthermore, since the late 1990s, hedge funds (which form part of "other financial institutions") have become prominent actors in the shareholder activist arena (Greenwood & Schor, 2009). However, they focus on corporate governance rather than on ethical issues and pursue activism as a profit-making strategy (Kahan & Rock, 2007), engaging with company directors with the objective of unlocking shareholder value. Overall, over the last 30 years, there has been a noticeable concentration of corporate ownership in the hands of institutional shareholders (Goergen, 2007) who, as Clark and Knight (2006) reveal, hold 70% of all listed equities in the UK.

A number of high-profile corporate scandals in the Anglo-Saxon world toward the end of the 20th century, such as Enron and WorldCom in the United States and BCCI in the UK and, more recently, the

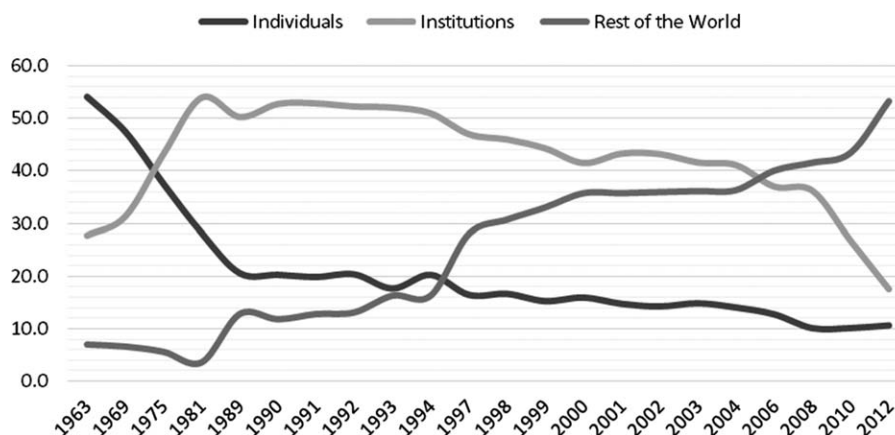


FIGURE 1 Historical trends in beneficial ownership in the UK (percentage of UK stock market owned by value)

Source. Compiled by the author based on data from the Office for National Statistics (ONS, 2012).

Note. Here, "beneficial owner" is defined as the person or body who receives the benefits of holding the shares, for example income through dividends.

TABLE 1 Historical trends in ownership (UK): insurance companies, pension funds, and financial institutions (percentage of stock market owned by value)

	1963	1975	1981	1991	2001	2008	2010	2012
Insurance companies	10.0	15.9	20.5	20.8	20.0	13.4	8.8	6.2
Pension funds	6.4	16.8	26.7	31.3	16.1	12.8	5.6	4.7
Other financial institutions	11.3	10.5	6.8	0.8	7.2	10.0	12.3	6.6

Source: ONS (2012).

global financial crisis, have led to a greater recognition of shareholders' responsibilities as owners. As a result, active ownership has seen a rise—in a recent study, Kolstad (2016) reports a change in institutional investors' approach toward engagement as a preferred SRI strategy. Similarly, citing data from Eurosif (2012), Sievanen (2014) indicates that, not only has responsible investment grown substantially, but more than 90% of the RI market comprises investments by institutional investors. A report published by Citi's Financial and Strategy Group in 2013 describes shareholder activism as "a sweeping trend that has spread to companies in all sectors and of all sizes, and increasingly, across all geographic regions" (Khorana et al., 2013, p. 1). The latest "Annual Review of Trends in Shareholder Activism" indicates that a total of 551 companies worldwide were subjected to activist demands in 2015, up 16% from the 344 recorded in 2014 (291 in 2013) (Activist Insight, 2016). In the UK context, 58 companies faced a public demand from activists, up from 44 in 2014 and 54 in 2013. Engagement and voting as a strategy has also experienced significant growth across Europe, with a 36% increase per annum from 2011 to 2013, reaching 3.3 trillion Euro in 2013 (Eurosif, 2014). Taking into account these figures, it could be argued that large institutional investors can and have started to play a role in encouraging responsible corporate behavior. The next section explores the literature with a view to reviewing the antecedents of activism and its effects on corporations.

3 | THE ANTECEDENTS AND EFFECTS OF MONITORING—EMPIRICAL EVIDENCE

The literature on institutional investor activism can broadly be divided into two strands which are briefly discussed here—namely, the effects of different investor characteristics on the propensity to monitor corporate behavior and the impact of investor stewardship on different variables such as firm performance, shareholder value, CEO turnover, among others.

The empirical literature which explores the antecedents of investor voice discusses factors such as the investment horizon, the size of institutional investors and the liquidity of a portfolio's firm stock, in an effort to explain why certain institutions act as monitors and others do not. However, the resulting findings are often ambiguous and contradictory. For example, the investment horizon of institutional investors is one characteristic considered to have an impact on active ownership.

On the one hand, it is believed that long-term, or dedicated (see Bushee, 1998), shareholders have an incentive to monitor the corporation as they are more interested in long-term profitability and likely to still hold the shares when the corresponding benefits arise (Chen, Harford, & Li, 2007; Neubaum & Zahra, 2006). On the other hand, short-term, or transient, investors such as hedge funds may have greater incentives to intervene and may do so more often in pursuit of short-term profits at the expense of long-term firm value (Bratton & Wachter, 2010).

The size of an institutional investor can also determine its propensity to be an active owner. Generally, investors with bigger stakes in their investee companies have higher monitoring incentives as their influence and resulting benefits from activism increase (Shleifer & Vishny, 1986). Furthermore, some believe that the liquidity of portfolio holdings attenuates the intensity of institutional investor monitoring (Almazan, Hartzell, & Starks, 2005), because it encourages shareholders to divest rather than intervene (Back, Li, & Ljungqvist, 2015). At the same time, Faure-Grimaud and Gromb (2004) find that higher liquidity can incentivize monitoring behavior as investors are able to reap the benefits of their engagement with companies, if they have to sell their shares prematurely.

Differences in regulations and corporate governance regimes may also explain variations in the degree of investor monitoring. The Anglo-American model of corporate governance (the UK being an example of a country that adopts it), is often contrasted to the Continental European corporate governance model (Becht & Roell, 1999; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Wen (2009) cites two characteristics of the Anglo-American corporate governance model which minimize the incentives for investors to monitor corporate performance—the fixation on shareholder value and the highly diffused ownership structure of corporations.

Apart from the antecedents outlined above, researchers have dedicated attention to analyzing the impact of monitoring on various aspects of the corporation. Callen and Fang (2013) provide empirical evidence that more stable institutional investors act as monitors and reduce future stock price crash risk, because they prevent management from hoarding bad news. In a similar vein, Cella et al. (2013) argue that investors with short-term horizons amplify the effects of market-wide negative shocks by demanding liquidity. Dimson et al. (2015) examine the highly intensive ESG corporate engagement activities at U.S. public companies between 1999 and 2009. The findings reveal that successful engagements generate cumulative abnormal returns of +7.1%. The research provides evidence that monitoring leads to improved accounting performance and governance of the targeted firms. The effects of monitoring on corporate governance are also explored by Aggarwal et al. (2011) who analyze the portfolio holdings of institutional investors across 23 countries over the period 2003–2008. They conclude that the greater presence of institutional ownership translates into higher likelihood of dismissing poorly performing CEOs, leading to improvements in valuation over time. Monitoring is also found to positively impact R&D spending as suggested by David et al. (2001) who conclude that institutional activism increases R&D inputs over the short term and the long term.

Overall, the evidence above suggests that the antecedents of active institutional ownership are complex and multifaceted. A variety of different factors need to be taken into account when explaining monitoring behavior and the results are not easily generalizable across contexts. At the same time, the literature is prolific in its description of the benefits arising from institutional activism. Taking these two conclusions into account, it would be beneficial to move away from the monitoring versus short-termism debate and ask a more pertinent question concerning the challenges to active ownership faced by UK institutions.

4 | QUALITATIVE RESEARCH METHODOLOGY

Direct knowledge of the interactions between institutional investors and portfolio firms is limited, especially in the UK context, where engagements (private dialogue) occur behind-the-scenes (Becht et al., 2010; McCahery et al., 2016). Therefore, the preferences and obstacles faced by investors are difficult to observe. Since the challenges to institutional investor stewardship are relatively unexplored (Sievanen, 2014), in-depth qualitative interviews served as an appropriate research methodology (Strauss & Corbin, 1990). In addition, given that the research is exploratory in nature and seeks to identify a variety of factors that have an impact on active ownership, the qualitative method surpasses the problems of categorical imposition typical of survey research and represents respondents' views more accurately (Alvesson & Deetz, 2000). Due to the nature of the enquiry, which required gaining insight into conditions of great complexity, the researcher needed to be able to adapt the interview questions and follow up issues as they arise. The flexibility afforded by the semi-structured interview facilitated this process (Bryman, 2008; Lewis and Nicholls, 2014). Similar qualitative methods have also been used by researchers examining the impact of shareholder activism (Hoffman, 1996; O'Rourke, 2003) and the shareholder activist strategies of NGOs (Sjostrom, 2007). In a multidisciplinary review of the literature on monitoring and activism, Sjostrom (2008) highlights the need for more empirical qualitative studies. Moreover, in a recent special issue on research methods in *Business Ethics: A European Review*, Campbell and Cowton (2015) emphasize the need for more qualitative research in the field, calling into question the often implicit assumption that a study has to be quantitative to be robust and legitimate.

4.1 | Data collection

Altogether, 25 face-to-face interviews were conducted with UK-based institutional investors (both SRI and mainstream), NGOs working with investors as part of their shareholder activist campaigns, service providers, and experts in the field of responsible investment. Table 2 provides a list of the organizations and individuals participating in the research. All interviews lasted between 40 and 90 min. They were digitally recorded and transcribed verbatim. Interviewees were reminded that their confidentiality will be safeguarded and that the researcher

sought their honest opinions (Oberseder, Schlegelmilch, & Gruber, 2011).

A design of an interview schedule preceded the beginning of the data collection process. Emerging questions, which elicit further elaboration and facilitate the exploration of leads, were also asked (Gubrium & Holstein, 2002). All interviews were conducted in the participants' natural work environment with a view of contextualizing the research findings and enhancing ecological validity (Creswell, 2003). The sample size reflects the author's desire to do justice to the richness of the qualitative data collected in the analysis by avoiding the pitfall of unnecessarily including a large sample. Instead, the focus was on quality, with the primary concern being to secure a sample which is highly rich in terms of constituents and the diversity it represents.

The initial set of questions in the interview guide allowed for a general discussion of the challenges to institutional investor monitoring of the corporation. Next, interviewees were asked to identify examples from their own practice based on specific interventions they have been involved in (i.e., obstacles faced by activist investors when monitoring portfolio companies; challenges to stewardship as reported by NGOs which work in collaboration with investors on ESG campaigns, and observations from service providers and independent consultants based on their investor clients' experience). In addition, questions were asked regarding the role of legislation for remedying the challenges and other steps that could facilitate effective monitoring.

4.2 | Interview sample

As the research has a UK focus, the participants were recruited from the UK. Most were based in London, reflecting the importance of the City as a major international financial center. Initial sampling was conducted by establishing a link with the leading charity in the UK working in the area of shareholder activism, which has extensive contacts in the investment and NGO communities (ShareAction). The first interviews were conducted based on referrals by ShareAction, and subsequent data collection was managed through a mixture of snowball and purposive sampling. The participants worked across a wide range of industries, including financial services and insurance, not-for-profit, consultancy, and academic to provide a more comprehensive perspective on the challenges to active institutional ownership. This sampling approach provides an opportunity to consider the behaviors and knowledge of different key stakeholders, which in turn makes the research robust and rich, shedding light on divergent aspects of the research question and avoiding bias (Ritchie, Lewis, Elam, Tennant, & Rahim, 2014). The institutional investors that took part in the study comprised both large mainstream investors and smaller SRI-oriented investors. There were a total of eight interviews with investors and investor coalitions (three with asset owners, four with asset managers, and one mixed), nine interviews with NGOs, three interviews with independent responsible investment consultants, four interviews with consultancy and research organizations specializing in providing services to investors, and one interview with an academic expert in SRI (see Table 2 which lists all interviewees in anonymized form). One possible limitation of snowballing sampling lies in the possibility to be left

TABLE 2 Interview participants

	Organization	Position of interviewee
1	A large SRI asset owner with set ethical investment policy and a track record of monitoring investee companies.	Ethical and responsible investment professional.
2	One of Europe's largest asset management companies based in the UK and invested across all major asset classes.	A specialist in active ownership and stewardship.
3	An asset management company managing investments for charities, the public sector, and religious organizations.	A member of staff responsible for the ethical and responsible investment strategy and engagement activities of the fund.
4	A church-based investor coalition of asset owners with a focus on issues of business, human rights, and environmental stewardship.	A senior staff member, overseeing the strategy of the organization.
5	An independent grant-making organization funding a change toward a better world in the UK and Ireland. As an asset owner, it holds a portfolio of investments in UK and overseas equities.	A member of staff responsible for the trust's investment strategy.
6	An investment management company with a long-term focus on listed consumer sector businesses in emerging markets.	ESG analyst.
7	A global asset management firm, whose assets under management amount to almost £274 billion across a range of funds, with £21 billion of assets in UK equities.	A senior staff member leading the monitoring activities of the firm.
8	Voluntary global network of pension funds, asset managers and insurers working to advance responsible investment.	A member of staff who works closely with investors and oversees their projects.
9	Independent responsible investment advisor.	
10	Responsible investment consultant to a number of charities with extensive experience in working with investors.	
11	Writer, editor, researcher, and consultant with previous experience in shareholder activism.	
12, 13	A leading global provider of social, environmental, and governance research. Providing independent analysis to responsible investors.	Two interviews—one with a senior staff member working in the area of responsible investment and another with a senior investment analyst with expertise in social, environmental, and governance research of companies.
14	Leading specialist organization working for investors to provide engagement and investment management solutions on ESG issues.	A member of staff working in the engagement team.
15	A global leader in sustainability research and analysis, providing insights to investors and financial institutions.	A member of staff working with UK investors to support their responsible investment strategies.
16	The leading UK charity which specializes in shareholder activism.	Senior staff member responsible for the overall strategy of the organization and closely involved in the campaign's work.
17	UK-based independent nonprofit organization which works with business, government, investors and other organizations to solve sustainability challenges.	Staff member working in the area of sustainable financial markets.
18	UK organization which works with investors and corporations on greenhouse gas emissions.	A senior staff member looking after the organization's investor relations.
19	A big international NGO with a focus on environmental issues and peace.	Staff member working in the area of capital markets and involved in shareholder activist campaigns.
20	A big international NGO campaigning on climate change, food, and biodiversity.	Staff member involved in shareholder activist campaigns.
21	An international NGO campaigning on human rights issues.	Staff member of the organization responsible for engagement with investors.
22	A UK charity focused on the social, environmental, and economic impacts of the global oil industry.	Writer and researcher involved in shareholder campaigns.
23	An international NGO working in the field of environmental and biodiversity conservation.	Staff member working in the area of sustainable finance.
24	UK think tank promoting social, environmental, and economic justice.	A member of staff working on a number of research and advocacy projects on reforming capital markets.
25	A top UK academic institution.	An academic focusing on responsible investment and corporate governance.

with a one-sided view of a topic if individuals recommend like-minded people as potential interviewees. To mitigate this problem, the snowballing sampling method was supplemented with a purposive technique which ensured that the researcher maintained a certain level of control over the sample in two ways—by directing key insiders as to the identities of individuals to whom they refer and by making a decision in terms of which of the potential informants would be interviewed (Bernard, 2002; Noy, 2008). A consideration was given to participants' experience (time spent in the organization) and knowledge of the responsible investment industry, alongside their involvement in different shareholder activist campaigns. The researcher investigated each organization's webpage and relevant documents to confirm the suitability of the interviewee, with a focus on those considered to be the most information rich participants, capable of providing a balanced and objective perspective. The snowballing strategy facilitated the gaining of access to senior level participants who have limited time and was also of benefit for gaining their trust.

4.3 | Data analysis

To analyze the data, the interviews were first transcribed and transformed into a coherent narrative (Silverman, 1993). The data were then thematically analyzed. This entailed condensing the data set (Coffey & Atkinson, 1996) by assigning codes to text of varying size such as words, sentences, and paragraphs (Miles & Huberman, 1994). Interviewees were allowed to comment on the interview transcripts resulting in clarification of the interpretation. A data-led approach to coding resulted in initial codes being generated for aspects of the data which seemed important. After a careful reading and re-reading of the interviews, initial codes were joined together in a meaningful way to form themes, based on repetitions and similarities across participants. Each theme represented a different challenge to active ownership and the number of times each of these was mentioned by different respondents was recorded. The themes were then ranked in descending order according to their prevalence in interview extracts. Table 3 provides a summary of the results and the ranking. The themes are ranked by "most often mentioned" in interviewee extracts—it would be inaccurate to draw conclusions about the importance of each factor on the basis of this ranking as this will likely vary among different stakeholders and depend on their characteristics, motivations, and perspectives. Rather, the results provide "a middle ground," an insight into the challenges that are relevant to a wider group of stakeholders with diverse inter-

ests. The next section discusses in greater detail the findings and compares the results with insights from the existing literature.

5 | CHALLENGES TO THE EFFECTIVE MONITORING OF THE CORPORATION: EMPIRICAL FINDINGS

Despite the fact that shareholder activism has passed through a process of maturation expressed in its adoption by an increasing number of large institutional investors (Sparkes & Cowton, 2004), a number of obstacles still exist and restrict investors' ability to effectively monitor investee companies. Understanding these impediments is of importance for policy makers trying to incentivize active ownership behavior, for NGOs wanting to influence the investment community, and for researchers seeking to explain investor behavior. Table 3 reveals the findings by listing the most widely cited challenges to active ownership identified by interviewees. The table ranks them according to the number of interviewees that have recognized each of the factors as a barrier.

5.1 | Misalignment of interests

To begin with, the results provide empirical evidence for McCahery et al.'s (2016) claim that the structure of the investment management industry impedes intervention as this was identified as a challenge by the greatest number of interviewees (11 out of 25). The decline of individual shareholdings and the reduction of investments in equities by pension funds and insurers have resulted in asset managers (or fund managers) becoming the dominant players in the investment chain (Kay, 2012). Asset managers are those who most often exercise the rights of active ownership associated with voting, or the buying and selling of shares. Despite this, their appointment, monitoring, and remuneration are based on short-term performance to the detriment of long-term value creation, as explained by one responsible investment consultant:

The main problem is fund managers are paid on short-term performance. You cannot expect someone who is incentivized on a short-term basis to think about the medium or long-term (Fieldwork Interview, RI consultant, 2013).

The situation creates a misalignment of interests between shareowners (the beneficiaries), some of which are long-term investors, and the actions of fund managers:

TABLE 3 Main findings

Rank	Impediment to active ownership	Number of interviewees who have identified it as a challenge
1	Misalignment of interests within the investment chain	11
2=	Lack of sufficient company transparency and investor experience in activism	10
2=	Internal conflicts of interest	10
3	Diversified portfolios and resource scarcity	8
4	Client inertia	7

The system is not working well... in the short term asset owners put the money with the fund manager, whose yearly bonus depends on really short-term performance against an index of stocks, and sustainability factors are not top priority. So, there's a mismatch between the incentives of the fund manager and the need for the client, the pension fund, for a much more long-term, sustainability oriented approach (*Fieldwork Interview*, NGO leading expert in RI, 2013).

Models of managerial myopia which suggest that executives of firms with high levels of transient investor ownership exhibit increased myopic behavior (Bushee, 1998; Matsumoto, 2002) could be applied to the behavior of fund managers. The structure of the market characterized by remuneration based on short-term performance drives myopia in fund managers.

Quarterly company reporting, which places a focus on the financial performance of the company's share price in the immediate future is another factor which only serves to exacerbate the problem according to interviewees. As a senior member responsible for the ethical investment strategy of an asset management company argues:

The most difficult part of it is quarterly reporting. The absolute focus on trying to deliver returns on a quarterly by quarterly basis and having that perception that a client would leave you because you've dragged below the line on that level is ridiculous and that's what is stopping effective stewardship to create long-term investment (*Fieldwork Interview*, asset manager, 2013).

The structure of the market is also believed to not be functioning properly due to the fact that price signals are much clearer in the short term—the financial impact of issues such as climate change is not reflected in financial calculations.

5.2 | Company transparency and investor experience in activism

The second most commonly cited challenge to investor activism relates to two issues—on the one hand, the lack of sufficient information on companies' social and environmental activities and, on the other hand, the lack of investor experience in terms of how to effectively engage with companies. Surveys of the ethical investment scene conducted by researchers identify information as the key to effective action (see Domini & Kinder, 1984; Ward, 1986). Yet, interviewed investors reported that their time and resources were scarce, limiting their ability to focus on ESG issues and to ascertain with clarity the problems with targeted companies on the ground. This observation was also reaffirmed by the responsible investments specialists and NGO members interviewed:

Asset managers and asset owners tend to be relatively under-informed and dependent on narrow streams of information

from industry analysts, rating agencies and other companies (*Fieldwork Interview*, NGO, 2013).

In addition, respondents identified that the main challenge stems from quantifying the financial impact that ESG factors are having on a portfolio:

The challenges are to identify what potential measurable impacts on the bottom line do ESG issues have and that's often difficult to do (*Fieldwork Interview*, research and engagement services provider, 2013).

The financial impacts resulting from sustainability, for example brand equity benefits, are very hard to measure. It is hard to link a positive approach to a wide range of sustainability issues with better returns for investors (*Fieldwork Interview*, asset manager, 2013).

In such a context, investors' reliance on company information becomes crucial. However, the current study suggests that company transparency is identified by interviewees as lacking sufficient detail. The need for more adequate information disclosure in annual reports is reflected in the words of one respondent working in the sustainability department of a major fund management firm:

It is sometimes not easy to understand to what extent a company is exposed to an issue, so better disclosure from companies might be useful (*Fieldwork Interview*, asset manager, 2013).

These results are substantiated by the previous literature. Harte, Lewis, and Owen (1991) assess the usefulness of the annual report for providing information on investment decisions and conclude that respondents share a strong degree of consensus about the insufficiency of information provided for appraising a company's performance in the area of CSR. In a similar vein, Perks, Rawlinson, and Ingram (1992, p. 62) argue that most annual reports "contain little to indicate companies' environmental activities" and Revelli and Viviani (2015) comment on the much less stringent reporting for social and ethical aspects compared with economic aspects.

Apart from sufficient information on company activities and the impact of ESG on financial returns, the findings reveal that activist investors often lack knowledge on how to conduct a successful engagement. As Becht et al. (2010) suggest, in the UK context, most investors tend to engage privately with companies via dialogue. However, there are few alternatives in cases when this engagement route proves ineffective:

Investors do talk to the companies but, if nothing improves, they keep their investment and there are no implications. This makes management question the saliency and the urgency of this engagement (*Fieldwork Interview*, academic expert in RI, 2013).

Public activism in the form of AGM attendance and filing of shareholder resolutions is one avenue for escalating an engagement. It is much more frequently used in the United States compared to the UK due to a regulatory system which facilitates access to corporate proxy statements (Louche & Lydenberg, 2006) and to cultural differences between UK and transatlantic investors (Ivanova, 2016). This failure to go beyond private dialogue could be explained by a lack of experience in other forms of shareholder activism:

To go to an AGM to ask a question you got to know what you do, how you do that, if you are going to table a resolution at an AGM, knowing how to present a resolution (*Fieldwork Interview*, asset owner, 2013).

More broadly, evidence of lack of investor experience in responsible investment is also found in a study by Sievanen (2014), who discovers that key decision makers face difficulties in defining RI in practice and implementing it at the individual and organizational levels.

5.3 | Internal conflicts of interest

The results show that conflicts of interest are also considered as a barrier to stewardship. Consistent with previous literature discussed above (McCahery et al., 2016), it was discovered that investors are sometimes reluctant to engage because they feel this could have a negative impact on their future ability to communicate with management and their relationship with the targeted company:

Investors in the UK are very concerned about upsetting the company and having the good dialogue channel closed (*Fieldwork Interview*, NGO, 2013).

Institutional shareholders need to be able to say they had X number of meetings with X number of people in the company, and they feel they won't get into those meetings, if they challenge the companies too robustly (*Fieldwork Interview*, RI consultant, 2013)

Similar to the findings of Brickley, Lease, and Smith (1988) and Cvijanovic, Dasgupta, and Zachariadis (2016) a small number of interviewees expressed the view that fund managers may refrain from contradicting management because of existing business ties and interlocked interests with the company:

Many fund managers are not very different from the companies they invest in, they are very big companies, they have in many ways the same interests, and they probably have senior executives who are on the board of other companies, which makes engagement difficult (*Fieldwork Interview*, NGO, 2013).

However, what was interesting to note was that the greatest emphasis was on internal conflicts of interest within institutional investors them-

selves and on conflicts of interest between investors who engage collaboratively on a topic. On the first point, interviewees suggested that often times the socially responsible investment department of an institution expresses interest in engaging on a specific topic, but this is met with disagreement from the equities department, or a lack of support from senior management:

Sometimes in a financial institution the CSR department is separated from the equity team, so the equity team do their investment, the CSR team do their engagement, but there is no connection between the two (*Fieldwork Interview*, academic expert in RI, 2013).

There are internal issues within institutional shareholders that are challenges to actual effective shareholder activism. Maybe the SRI team really want to do something, but the traditional equity team won't let them and that's a completely internal thing (*Fieldwork Interview*, RI consultant, 2013).

As shareholders generally have diversified portfolios and hold small stakes in any given company, cooperation between them is key to influencing corporate strategy (Marinetti, 1998). However, conflicts of interest also arise during collaborative engagements between investors due to the existence of what Scott (1985, p. 51) terms a "constellation of interests." The empirical data suggests that the divergent interests of investors and their different time horizons (transient versus dedicated investors as labeled by Bushee, 1998) undermine the impact of their campaign:

Collaboration by multiple investors is more persuasive to companies, but not always that easy to achieve because in engagement activities each participant has its own agenda and views (*Fieldwork Interview*, ESG senior investment analyst, 2013).

5.4 | Diversified portfolios and resource scarcity

Diffuse ownership—a central characteristic of the Anglo-American model of corporate governance—is another challenge to effectively monitoring the corporation according to interviewees. Useem (1993) draws on the idea of resource dependency as a critical lever of power to explain that the power of company B over company A is a result of the reliance of A on the resources of B. Therefore, when ownership is dispersed, there are so many shareholders that the corporation is dependent on no one in particular.

Large publicly traded corporations, each owned by many shareholders, came into being at the end of the 19th and the beginning of the 20th century as a result of the absorption of a considerable number of small and medium-sized companies (Bakan, 2005). Bakan (2005) argues that, in these large corporations, the thousands, or even hundreds of thousands of shareholders, have little influence over managerial decisions. As individuals, their power is diluted and their broad

dispersion also precludes them from acting collectively. The latter statement is substantiated by the empirical findings of the study:

The main issue is that the ownership is very dispersed. We normally only own a small fraction of the company, so it's the variety of shareholders that companies have and the different levels of interest in exercising stewardship (*Fieldwork Interview*, asset owner, 2013).

Having a diversified portfolio of shares dilutes the influence of investors, making it more difficult for them to organize and collaborate effectively. Another factor which diminishes their influence vis-à-vis management is the lack of sufficient resources (both people and time) that would otherwise facilitate an investor campaign:

Resources, that's the single biggest challenge. If you invest, like we do, in hundreds and hundreds of companies, to research them properly, to understand the issues that they face, and to engage with them effectively over a period of time, is very resource intensive (*Fieldwork Interview*, asset manager, 2013).

These results are consistent with previous literature. Wen (2009) cites the diffused ownership structure characteristic of the Anglo-American model of corporate governance as a defining factor in the passivity of institutional investors and their preference for exit (selling of shares) over voice (monitoring). A survey of 143 large institutional investors across countries conducted by McCahery et al. (2016) also reveals that respondents identify lack of resources, small stakes in companies, and diversified portfolios across many companies as barriers to monitoring management.

5.5 | Client inertia

The fifth and final challenge to active ownership is the lack of client demand for engagement on ESG issues. This refers to insufficient oversight of fund managers by their clients—asset owners such as pension funds, charities, foundations, insurance and sovereign wealth funds, and retail investors, which do not incorporate sustainability considerations in fund managers' mandates and do not encourage them to engage with investee companies with a view to improving their social and environmental practices:

A lot of the people we talk to in the asset management world say "Look, we really want to do this, but we get so little demand from clients. We just don't get pension funds asking us about social and environmental issues" (*Fieldwork Interview*, NGO working closely with investors, 2013).

Fund managers are paid to do a job and, if they are not incentivized, and in fact are actively disincentivized, from being active owners of companies, then they are not going to do it (*Fieldwork Interview*, RI consultant, 2013).

Change has to come from client demand and wider societal expectations (*Fieldwork Interview*, asset owner, 2013).

Although not limited to one type of asset owner, such inertia is particularly problematic for pension funds, given their large shareholdings and their fiduciary duty, or legal obligation to act in the best interests of pension savers. Pension funds in the UK are among the largest asset-owning types of investors (Maslakovic, 2011) and the UK is the second largest market after the United States with about 10% of the world's total pension assets. Hess (2007) expresses optimism about the ability of public pension funds to act as a powerful catalyst for change in the social and environmental practices of companies, and believes they can serve as surrogate regulators. In similarity to these arguments, as early as the 1970s, Drucker (1976) also acknowledged the importance of the growth of private pension provision and of pension funds who have become the controlling owners of America's largest companies. Yet, despite their potential for bringing about change, the current empirical findings, as well as previous research (Hess, 2007), suggest that, in their majority, pension funds, alongside other types of asset owners, are currently not acting as long-term stewards.

This lack of oversight on the part of pension funds could be explained by looking further down the investment chain to their clients—the pension savers. British sociologist Robin Blackburn's (2002) main argument is that employees (pension savers) should exercise democratic control over corporations and should ensure that their practices benefit them, their families, and the communities they live in rather than the financial services industry. The findings of this study suggest that there is demand from within the investment management industry for pension savers to become more involved and express their views on how their money is managed. Furthermore, their involvement is seen as a factor that could drive a change toward greater active ownership by asset owners:

Change in the behaviour of investors towards greater engagement is possible if more pension scheme beneficiaries were asking about these issues (*Fieldwork Interview*, fund manager, 2013).

I would love there to be an opportunity for the beneficiaries to express pleasure or concern at the execution by the individual fund managers of the Stewardship Code (*Fieldwork Interview*, fund manager, 2013).

Clark and Hebb (2004) criticize Drucker's argument on the basis that he fails to outline the mechanisms by which such dispersed ownership can be unified to undertake concerted action. According to Clark and Hebb (2004), although the role of pension savers is widely discussed, they are unable to sustain their position as central actors. Instead, they envision a world where pension funds act as single industry players who take decisions on behalf of pension savers but are not controlled by them. Previous studies have suggested that NGOs can serve as the mechanism that unifies pension savers to undertake concerted action and to regain center stage and show evidence that pension savers can be mobilized around a particular issue (Richardson, 2007). However,

important as savers might be, the empirical findings suggest that the movement that empowers people to know where their pension savings are invested and to push for change is still in its nascent state and, as argued by a sustainability research expert at a mainstream fund manager:

At the moment, a relatively tiny proportion of pension savers ask any questions at all about these issues and some pension funds use that as an excuse to do nothing. So the more pension savers ask, the better (*Fieldwork Interview*, fund manager, 2013).

6 | Implications and conclusion

The current study, based on a total of 25 qualitative interviews, has systematically discussed the challenges to investor stewardship in the UK context. The literature on the subject suggests that institutional investors' ability to monitor the corporation is hindered by a number of different factors. The free rider problem occupies a central place in the discussion. Shleifer and Vishny (1986) argue that large shareholders have an incentive to monitor because the return on their shares is big enough to cover the monitoring costs. However, other smaller shareholders also benefit from gains on their shares. According to Grossman and Hart (1980), minority shareholders wishing to free ride on the improvements generated by a corporate raider diminish the potential profit the activist investor can generate. This leads to failed takeover bids and a situation where bad management is not penalized. Research predicts that the larger stake size of shareholders (Agrawal & Mandelker, 1992), as well as a larger number of blockholders (Edmans & Manso, 2011; Noe, 2002), reduce the free rider problem. It is interesting to note that, although featuring prominently in the literature, only a very small number of interviewees in the study identified the free rider problem as a challenge to engagement.

Investor activism may also be hindered by fears of breaching legal rules. In an effort to explain the drivers of shareholder passivity in the United States, David and Thompson (1994) cite diversification requirements that prohibit banks and mutual funds from owning control blocks that would otherwise increase their influence (Roe, 1991), as well as rules that make collaborative action between investors difficult (i.e., rule 13D in the United States or the risk of making a public offer in Europe).

In addition, conflicts of interest can serve as a deterrent to investors who want to engage with management. Brickley et al. (1988) provide evidence that certain types of investors such as insurance companies, banks, and trusts are less likely to oppose management when voting on antitakeover amendments because of existing business relations they have with the firms. Similarly, Cvijanovic et al. (2016) find that business ties with portfolio firms lead to pro-management voting by mutual funds. A survey of 142 large institutional investors by McCahery et al. (2016) confirms that conflicts of interest are of importance as the results reveal that investors believe monitoring leads to problems with receiving information from targeted firms. From a theoretical perspective, Juravle and Lewis's (2008) framework also cites

conflicts of interest as an institutional impediment to engagement. Nevertheless, the framework does not draw a distinction between internal and external conflicts, nor does it reflect on the relevant importance of one versus the other. Similarly, previous research cited above (Brickley et al., 1988; McCahery et al., 2016) remains silent on the subject of internal conflicts of interest and instead emphasizes external conflicts between institutional investors and companies. However, the findings of this study place an emphasis on the importance of internal conflicts of interest within institutional investors themselves as an inhibiting factor which prevents effective monitoring. It was discovered that different departments within institutions often have differing views on whether the organization should engage or not.

The structure of the investment management industry and the corporate governance framework within which investors operate can also be impediments to shareholder activism. For example, fund managers may not engage due to a lack of encouragement by asset owners who do not reward activism (McCahery et al., 2016). In the context of the Anglo-American corporate governance model, the deeply rooted idea of shareholder value, the highly diversified ownership structure and liquid markets, are all factors that minimize the incentives for monitoring (Wen, 2009). The results provide empirical evidence which validates existing inferences made in the literature about the misalignment of interests within the investment management industry (McCahery et al., 2016) and the dispersed ownership structure of the Anglo-American corporate governance system. It is interesting to note that the most commonly cited challenge in this paper bears no relation with the individual preferences of investors and instead has to do with the structure of the investment management industry which results in misalignment of interests. This conclusion also has implications for policy makers as it reveals that the barriers are great in scale and would be facilitated at least in part by regulation.

The findings are largely consistent with previous theoretical and empirical studies which cite free rider problems, conflicts of interest, lack of information and diffused ownership as barriers (Coffee, 1991; Cvijanovic et al., 2016; Duan, Hotchkiss, & Jiao, 2016; Grossman & Hart, 1980; Harte et al., 1991). However, the study contributes to the existing literature by shedding light on barriers which have so far been unexplored, for example, the existence of client inertia in terms of engagement on ESG issues, internal conflicts of interest, and lack of investor experience in activism. Juravle and Lewis's (2008) theoretical framework could thus be extended by adding the "client inertia" variable to the "institutional impediments" level, as well as "insufficient experience" to the "organizational impediments" level. In addition, the paper has discovered that shareholder activism is also inhibited by inconclusive evidence regarding the link between sustainability and financial performance and the impact of ESG factors on investment portfolios. Indeed, the empirical literature to date has provided mixed results with regard to the link between shareholder activism and corporate financial performance, with scholars reporting positive (Cunat et al., 2012; Klein & Zur, 2009), negative (Cai & Walkling, 2011; Karpoff, Malatesta, & Walkling, 1996), and insignificant market reactions to activism (Agrawal, 2012; Revelli & Viviani, 2015). According to Revelli

and Viviani (2015) such divergent results are due to the heterogeneity of SRI definitions and the methodologies used to measure its effects. Although the lack of consensus on the topic is universally accepted, the current paper provides evidence of the effects of this lack of consensus on investor behavior. The paper has contributed to the monitoring versus short-termism debate in the literature by going beyond traditional explorations of the characteristics of active investors and the link between stewardship and financial performance. Instead, the study has explored an alternative research question which considers the structural conditions and macro environmental factors that hinder active investors' monitoring activities. The research also contributes to the work of Juravle and Lewis (2008) by providing a more detailed view of how organizational and institutional factors can serve as impediments to investor activism.

In view of the importance of identifying the impact of ESG factors on financial performance, and given the conflicting views in the literature, future research could work toward establishing a greater degree of consensus on the topic. This would require better operationalization and consistent use of concepts across studies, as well as more studies quantifying the impact of monitoring on returns. The current paper has shed light into the challenges faced by institutional investors in the UK, but future research could explore the barriers in different geographical contexts. In addition, research could analyze the root causes of client inertia and study pension savers' general awareness and willingness to adopt a more involved role in their investments. Given the fact that the misalignment of interests was identified as the most significant barrier by interviewees, future enquiry could focus on advancing ways of reforming the structure of the investment management industry by proposing alternatives to existing institutional logics.

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CONFLICT OF INTEREST

Author Mila Ivanova declares that she has no conflict of interest.

NOTE

¹ Cowton (1994, p. 215) defines SRI as "the exercise of ethical and social criteria in the selection and management of investment portfolios." In this study, the term responsible investment is shortened from socially responsible investment (SRI). Responsible investment is an umbrella term that encompasses a variety of investor strategies—both passive investing (negative and positive screening) and active investing (shareholder activism or monitoring) (see the 2014 European Sustainable Investment Forum's SRI survey which outlines these strategies in detail).

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