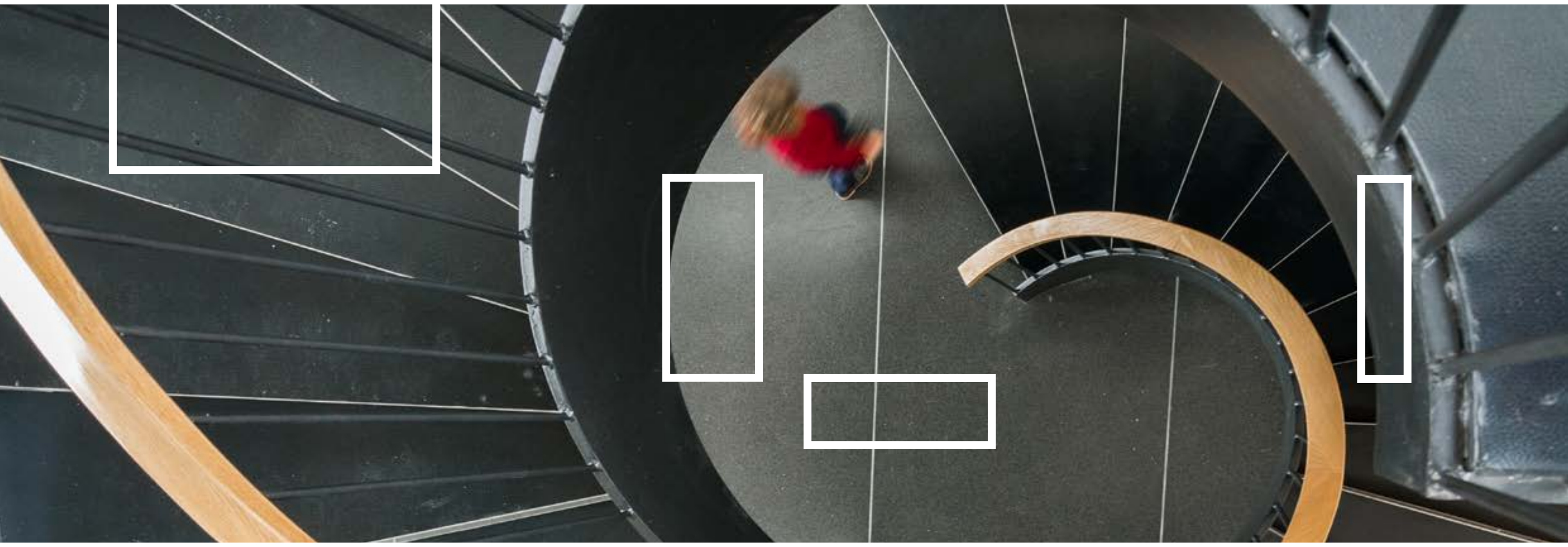
The rights of perpetual creditors

Stewardship in fixed income



"Equity shareholders have all the power to exert influence over company management and corporate strategy".

False.
What was an accepted wisdom for many years has, in our opinion, been dispelled in recent times.

Equity shareholders do have significant powers, most notably the power to vote at shareholder meetings and thus the power to potentially directly influence the appointment and remuneration of board members and senior management, as well as the outcome of share issuance and buybacks, mergers and takeovers. Conversely, bondholders do not, except (sometimes) in the case of bankruptcy or change.

However, there are four crucial points that can be overlooked.

1. **Based on our observations, corporates have consistently increased leverage (and achieved falling credit ratings) over the last 30 years.** They are not issuing fresh equity on the whole, providing less need to appease new equity investors.
2. **Equity is perpetual – a seller is replaced by a buyer (although that buyer may be the company).** This supports the case for stewardship in equity, particularly passive equity, where investors will be perpetual shareholders.
3. **But large borrowers, with or without listed equity, are likely to refinance rather than repay debt.** They will work to have liquid bonds trading in various markets, so they have as many sources of funding as possible. This means they are continually launching new issues, requiring engagement with creditors, and long-term holders of debt are likely to be perpetual creditors of these borrowers.
4. **The recent pandemic has led many entities to borrow significant amounts of money from the government, the banks and the market.** We believe that not all borrowers will be able to repay this extra debt in the short-term and will have a greater need to consider the interests of bondholders for some years to come.

So, stewardship in fixed income is a position of significant influence for all borrowers, not just corporates.

Most active fixed income managers have recognized this for some time and have been improving their stewardship activities with borrowers, including sovereign and government-related issuers, although some houses are notably lagging peers in their efforts.

Many indexation managers now consider themselves as long-term stewards of their clients' equity capital (see our previous paper: *"Looking to improve stewardship"*). Based on our experience, indexation manager have not regarded themselves as long-term stewards of fixed income capital. Further, they seem to conduct little to no engagement with bond issuers that do not have listed equity.

Defined benefit pension plans approaching maturity are selling return-seeking assets (including equities) and reinvesting the proceeds into credit. There may also be a similar shift in the baby-boomer generation's own portfolios as they progress towards retirement.

At the moment, we believe this means stewardship activity in investors' total portfolios is likely to decrease as they switch to fixed income, particularly if they invest in passive strategies or those with high exposure to issuers without listed equity.

We recommend investors raise the issue of stewardship with managers before they invest in fixed income mandates and hold managers accountable to objectives to ensure the level of oversight is not diminished.

The minimum standards for indexation strategies is evolving and we feel that what may have been acceptable five years ago simply won't work anymore. Investors need to play an active role in engaging with their managers on the topic to ensure the industry continues to move forward.

We find this disappointing given the considerable amounts of money in passive fixed income mandates, and also surprising given the increasing number of ESG-tilted fixed income strategies. Additionally, some of these large managers make great efforts to tout their stewardship credentials.

Improving practice

In our view steps that indexation managers should consider to improve their stewardship activity include:

- Recognizing that the interests of equity and credit investors coincide in many cases but sometimes conflict, e.g. during takeovers, bankruptcies, share buybacks, and establishing policies to deal with those conflicts.
- Engaging with corporate issuers on a regular basis and considering the interests of all investors when doing so. For example, when engaging on C-suite compensation metrics, it might be relevant to include a duty to consider the interests of all relevant stakeholders rather than just equity holders.
- Engaging with government-related issuers on a regular basis, particularly in ensuring the Board is not dominated by political appointees but includes members with experience appropriate for the industry or activity the issuer is involved in.
- Engaging with sovereign issuers on a regular basis. The topics covered will be rather different than those which matter for corporations but the aim should be the same: to improve the overall characteristics of the issuer. We do not agree that engagement with government borrowers is likely to be ineffective but we recognize that it is more likely to lead to improvements when a sovereign is issuing debt denominated in a currency not their own. We would expect managers running global government bond mandates to engage with government issuers.
- Engaging with service providers of securitized issues on a regular basis, particularly in ensuring they are not pursuing policies that may result in reputational damage, for example, inappropriately aggressive pursuit of delinquent borrowers.
- Improving their reporting systems so they can report engagement activity on a mandate-by-mandate basis, rather than at the overall firm level. This will become necessary given Trustees' need to demonstrate to their members (and the regulators) that they are effective stewards of the capital they oversee.

"We encourage indexation managers to review their stewardship activities and improve practices so they cover the full range of assets under management to a consistent standard.

For more information please contact your usual Willis Towers Watson consultant or:

Kate Hollis
+44 207 170 2809
kate.hollis@willistowerswatson.com

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