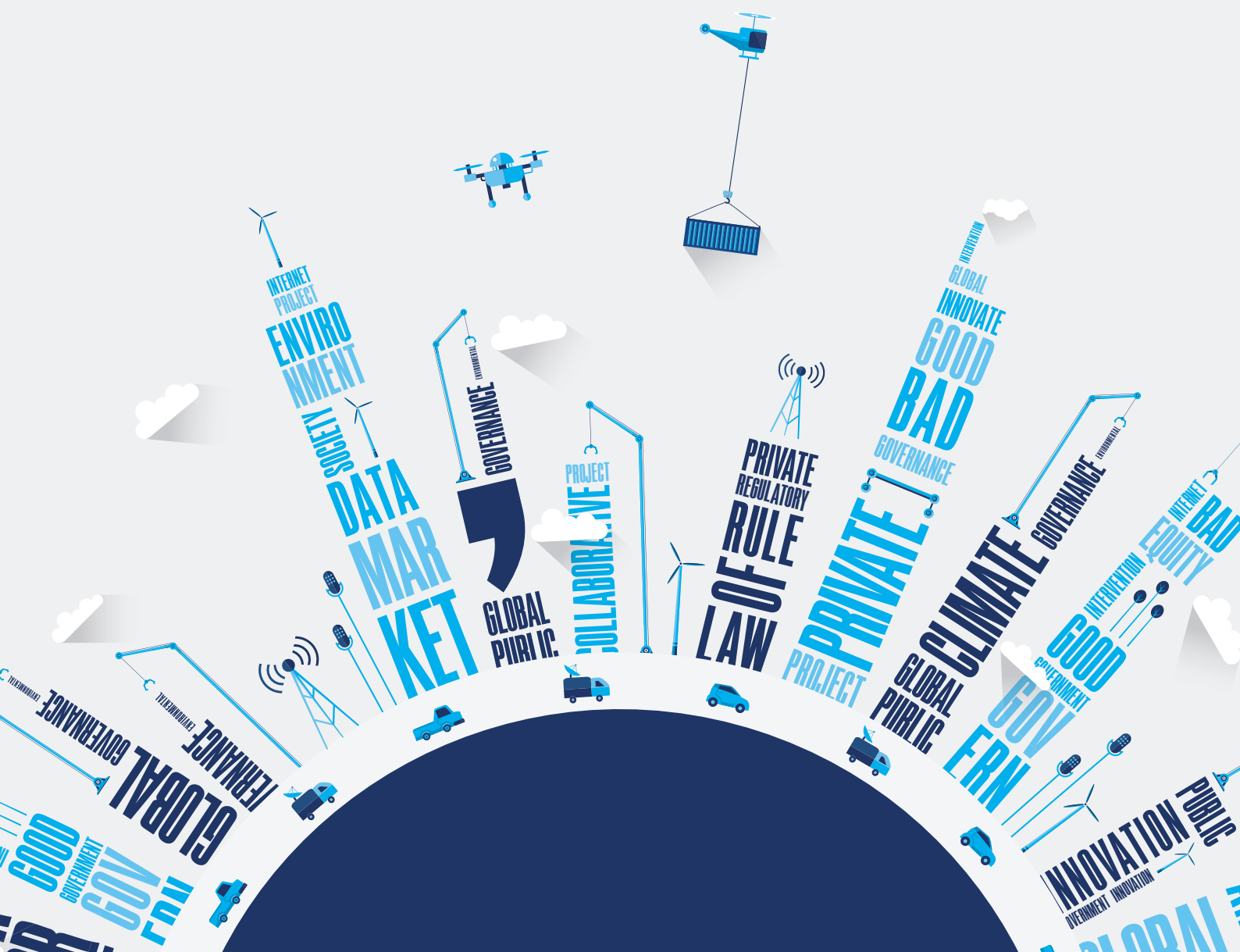


New risks, new rules

In a changing world, what should good governance look like?

Investor attitudes to the importance of governance in their investment decision-making

Research report, November 2015



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Foreword

Good corporate governance is at the heart of Aberdeen's business. We are committed to being transparent in all our activities and reports, and follow best practice in day to day operations because we believe this makes our business easier and more efficient to run.

Aberdeen looks for companies with financial strength and sound corporate governance practices in which to invest. Once invested, we exercise responsible ownership with the conviction that companies adopting best practices in corporate governance will be more successful in their core activities and deliver enhanced returns to shareholders.

In the 32 years since Aberdeen was founded, there has been a remarkable period of global economic transformation and the governance of countries and of the world economy has advanced markedly.

The most recent financial crisis underscored the need for better integration between monetary policy and governance frameworks. While there has been progress in aligning the two, there is much more to be done. The governance of countries affects the ability of companies to generate value within them, and it is in everyone's interests to enhance the framework for business.

Our industry has to continue to work hard to adapt to events, new ideas, and changes in the economic and financial environment. In doing so, we must continue to work closely with regulators and policymakers, and put into practice genuinely long-term measures to support an investment environment that is stable and sustainable. The governance of the investment process is developing, and it is right that clients are asking increasingly demanding questions of their fund managers.

This report offers a timely reminder that governance – at all of these three levels – does not stand still and that as fast as the world changes, we must evolve in response. It shines a spotlight on the issues that sometimes make this difficult, potentially rewarding, but most of all essential.

Martin Gilbert
Chief Executive
Aberdeen Asset Management



Introduction

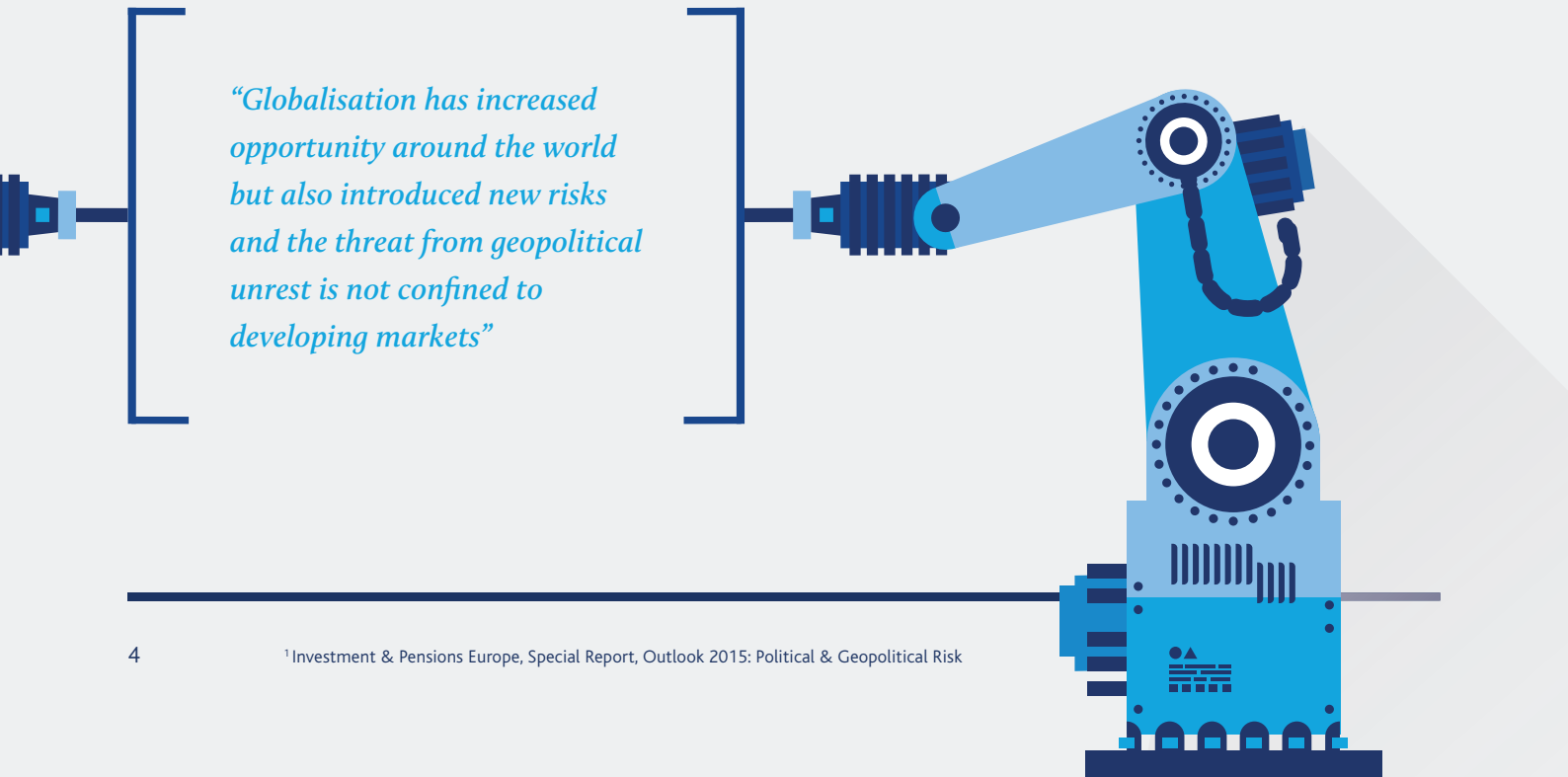
Increased connectivity, globalisation and the attendant risks call for new measures to assess strategic investment potential

In the increasingly interconnected world we inhabit, changes at country level are felt at company level more rapidly nowadays than perhaps at any time in history. While globalisation has increased opportunity around the world it has also introduced new risks and the threat from geopolitical unrest is not confined to developing markets.

However, geopolitical risk does not automatically lead to portfolio risk. In a report published by Investment & Pensions Europe¹, it suggests that rising geopolitical tensions have not led to rising financial market volatility, partly because of volatility-dampening central bank intervention, the changing nature of geopolitical risk, and the lack of specific transmission routes into the financial system – but this will not necessarily last. "Political, trading and financial interconnectedness may look like transmission routes, but currently act as brakes on geopolitical brinkmanship. Faster global communication and new financial instruments have also helped markets respond to geopolitical news more quickly and smoothly. The one element likely to change soon is central bank intervention – geopolitical sensitivity in investment portfolios could rise as liquidity is withdrawn." The investors who contributed to our research were all too

aware of this and recognised the profound influence of country events on their investment decision-making. At the same time as the world is experiencing heightened geopolitical uncertainty, the perception of markets and opportunities is also undergoing a profound change. Until recently, markets were assessed on the extent to which they were 'developed' or 'emerging' whereas the distinction between the two has become more difficult to define since the 2008-2009 financial crisis.

Furthermore, the assumption that the major political features of emerging markets would converge towards a US or UK model has not materialised, as most have moved towards less liberal forms of governance in the wake of the crisis. The BRIC (Brazil, Russia, India and China) economies that emerged at the beginning of the millennium were only expected to meet their long-term growth targets if political leaders were willing to develop institutions and maintain policies that were adequately supportive of growth and stability, in other words, if they were well governed. When the financial crisis triggered a global economic slowdown, governance moved centre-stage. As quickly as this economic landscape transformed, it is changing again. Developing countries represent half of global GDP and yet unstable governance of a number of these nations threatens to undermine their prospects.



"Globalisation has increased opportunity around the world but also introduced new risks and the threat from geopolitical unrest is not confined to developing markets"

Governance is the new differentiator

Sources of strategic investment opportunity around the world have clearly become more difficult to quantify and the focus is moving towards governance as the new differentiator. Author and political scientist Ian Bremmer suggests that investor priorities should be stability and resilience; markets where "good governance and sustainable growth are likely to go hand in hand."² John Paul Smith, founder of global equity asset allocation consultancy Ecstrat, says: "Instead of the existing division between emerging and developed markets, we suggest that investors focus their analysis on the sovereign and governance characteristics of individual countries and markets using a framework based on six types of governance regimes as a starting point."³

New measures

While governance regimes at the country level do not constitute investable asset classes as such, they nonetheless represent an increasingly important basis for country-based investment analysis and measure of potential opportunity. In the same way, investment managers need actively to consider corporate governance at the level of the companies in which they invest – as the OECD (Organisation for Economic Co-operation and Development) suggests "good governance by institutional asset owners makes a significant incremental difference to value creation as measured by their long-term risk-adjusted rate of return."⁴ There is a third level of governance too: governance and oversight of the investment process, about which some studies go so far as to suggest that effective governance may add as much as 100 to 300⁵ basis points to investment returns. For Aberdeen, all three levels of good governance are important and are given active consideration in our approach.

Our research examined how investors perceive today's governance challenges, from country to company; the impact of influences in their region, industry and organisation; their understanding of the opportunities for organisational improvement and value creation that good governance and stewardship might offer; and finally the investment challenges, in particular the importance and difficulty of investing for the long term.

"Sources of strategic investment opportunity have become more difficult to quantify and the focus is moving towards governance as the new differentiator"

Research method

293 decision-makers participated in the research, which comprised a quantitative survey of 278 respondents and qualitative interviews of 15 senior professionals conducted by Gabriel Research & Management Ltd. Contributors included trustees, finance directors, pension managers and consultants across the financial services industry, corporate and not-for-profit sectors. The survey had global reach, with participants from the UK and elsewhere in Europe, North America, Canada and the Asia Pacific region.

The online survey was open between 21 September and 12 October 2015. Interviews took place between 3 September and 8 October 2015. For reasons of client confidentiality, some comments are not attributed.

² Ian Bremmer, 'The new world of business', Fortune.com, 22 January 2015

³ John Paul Smith, FT.com, 12 August 2015

⁴ <http://www.oecd.org/daf/ca/corporategovernanceprinciples/43654500.pdf>

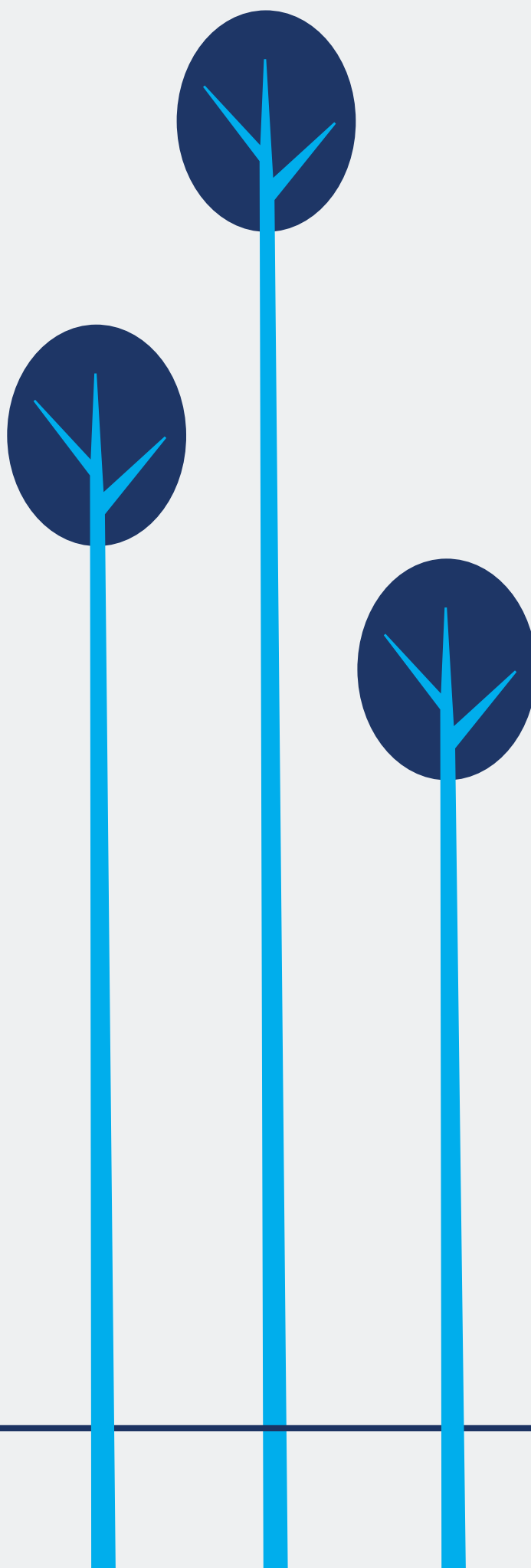
⁵ Best-practice pension fund governance, Gordon L Clark and Roger Urwin

Executive summary

The research surveyed a total of 293 investors, trustees, managers and consultants across the financial services industry, corporate and not-for-profit sectors. The survey had global reach, with participants from the UK and elsewhere in Europe, North America, Canada and the Asia Pacific region.

The findings suggest that the importance of governance is well recognised and is at the core of interaction and analysis, from the initial assessment of investment opportunities within country-based research, to the evaluation of investee companies and those responsible for managing and overseeing investment decisions. Governance competency frameworks were perceived as quantifiable and disciplined but not necessarily sufficiently dynamic given the pace of change they need to encompass.

Respondents agreed that governance should embrace every aspect of an organisation's operations and finances, as well as the economic and political risks relevant to the geographic context in which it operates, to support effective decision-making. However, the extent to which governance needs to be responsive to changing events, from outside the organisation and within it, was perceived to be a significant and persistent challenge. The resources needed to master the scale and scope of governance in today's world amidst heightened geopolitical risk and persistent market volatility, not to mention relentless regulatory change, were reported as increasingly difficult. This in turn makes planning and investing for the long term even more demanding.

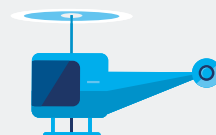
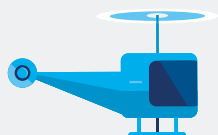


- 89% of respondents agreed that effective governance is a critical driver of investment performance.
- 81% of respondents expected their focus on risk management to increase over the next few years.
- 'Governance competency and preparedness' was among the top three biggest concerns to respondents' own organisations.
- 57% believed that country governance regimes/competencies constitute a better measure of opportunity/risk than the traditional emerging/developed market definitions.
- 85% said that asset managers should engage with the companies in which they invest client funds, both at the pre-investment due diligence stage and at regular intervals subsequently. This does not necessarily mean that asset managers are expected to attend shareholder meetings (only 7% mentioned this).

- Respondents reported that asset managers should engage with investee companies on a wide range of topics, notably: corporate governance standards (cited by 92% of respondents), board diversity, structure and succession planning (83%), and corporate actions/takeovers (76%).
- Views were polarised on how effective asset managers are at engaging with the companies in which they invest:
 - 43% of respondents said that their asset managers are effective in this respect
 - 37% indicated that they are not
- 70% agreed that 'a short-term, peer-sensitive environment makes it difficult to truly think and act long-term.'
- 48% agreed that 'regulations force short-term thinking and acting.'
- 42% agreed that 'changing relationships with outsourced providers (e.g. consultants, asset and investment managers) can make it difficult to sustain long-term strategy.'



Country risks and trends



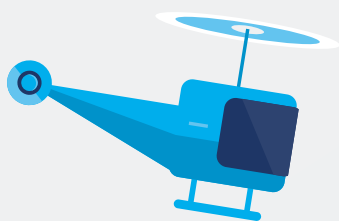
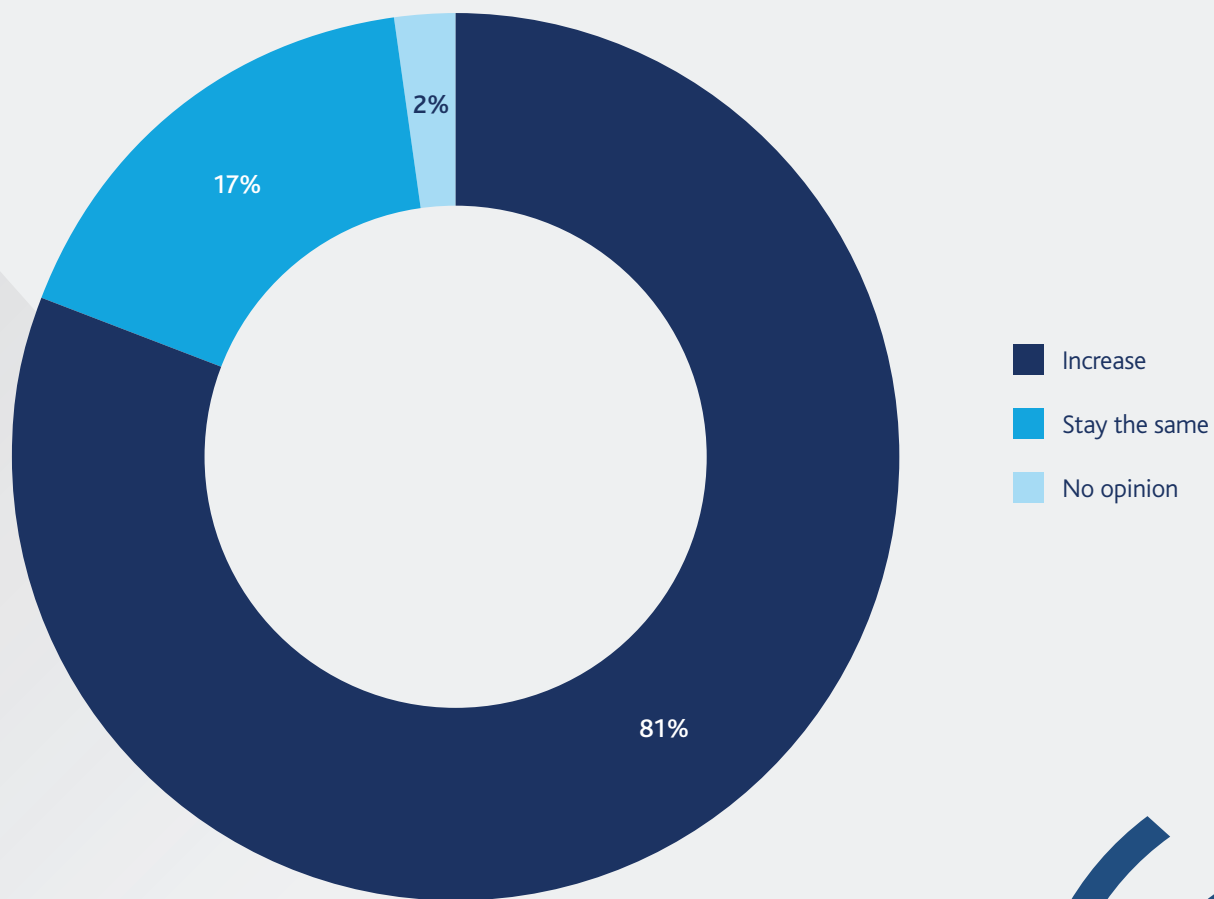
The World Economic Forum Outlook on the Global Agenda 2015 identifies the top 10 trends and key challenges facing the world's regions as follows:

1. Deepening income inequality
2. Persistent jobless growth
3. Lack of leadership
4. Rising geostrategic competition
5. The weakening of representative democracy
6. Rising pollution in the developing world
7. Increasing occurrence of severe weather events
8. Intensifying nationalism
9. Increasing water stress
10. Growing importance of health in the economy

As global investors, respondents recognise that events happening around the world are as relevant to them as domestic issues.

In its 2015 Global Risks report, the World Economic Forum⁶ (WEF) identified the top 10 trends and challenges facing the world's regions, (see above). We talked to respondents about these trends and challenges and in particular, to what extent increased connectivity and globalisation have created new opportunities but also brought new threats and risks. The findings were clear: 'Governance competency and preparedness' was among the top three biggest concerns and 81% respondents reported that their focus on risk management will become even stronger over the next few years (see Q1).

Q1. Do you expect your/your organisation's focus on risk management over the next few years to increase, decrease or stay the same?



As global investors, they recognise that events happening around the world are as relevant to them as domestic issues. They perceived the key trends identified by the WEF as inter-linked, falling into three over-arching categories: the environment (particularly pollution, increased water stress, severe weather events and the causal effects of climate change); government stability and governance (e.g. intensified nationalism, rising geostrategic competition, weakening of representative democracy, lack of leadership); and investment opportunities/threats (the growing importance of health, deepening income inequality, and persistent jobless growth). The environmental theme was perceived to be one of the most compelling challenges globally.

Attitudes to the effect of pollution were reflected within, and supported by, an increased engagement with SRI (sustainable and responsible investing, or socially responsible investing), which is gradually becoming a more central tenet of investment strategy overall – and not just to those who have interests in the energy sector. As Lawrence Johansen, Director of Investments, New Hampshire Retirement System (USA) said: "Water stress and pollution are obviously related to each other. The three big issues in China, for example, are pollution, corruption and stabilising the banking system; and pollution is by far the number one concern."

'Deepening income inequality' was also reported as one of the most important challenges; it was perceived as having a significant impact on share price, local economies and societal cohesion globally, in the same way that 'persistent jobless growth' would influence the socio-political, economic and investment environments. As Lorelei Watson, Head of Treasury, Pensions and Capital, at the London Borough of Hounslow (UK) put it: "Deepening income inequality is one reason for the weakening of representative democracy." Other respondents agreed: "In North America the whole issue of income inequality is getting a lot of attention. We are seeing a lot more evidence that it is detrimental to the economy."

Erik Carleton, Director of Pension Investments at Textron Inc. (USA) said: "Income inequality has to do with US wage rates and how that affects profitability of stock and how wage pressure also affects inflationary pressures. Any change in the paradigm of income equality or inequality is going to have ripple effects through the stock market."

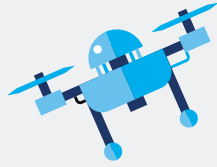
'The growing importance of health in the economy' was perceived to be both an investment opportunity and a driver of inflation. Erik Carleton said: "The demographic reality the world is facing through the next fifty years is going to have something to do with inflation, specifically in healthcare. A lot of people say there is no inflation in certain things, healthcare is one where there is actually inflation."

Across all regions, respondents were acutely aware of the influence of global, geopolitical influences on their investment decision-making.

Responding to the list of top ten risks and trends identified by the WEF they expressed concern that free trade and currency stability in particular were threatened by the weakening of representative democracy, intensifying nationalism and lack of leadership.

One North American respondent said: "Intensifying nationalism is certainly pertinent to investors exposed to the resource sector, which is being affected by efforts in other countries to nationalise their resources. If you deal with companies which operate overseas where there is not necessarily the government infrastructure to support a truly democratic society, a lot of emphasis gets placed on the communities that are impacted by those projects. If those two things don't mesh together it definitely leads to problems from an investment perspective."

It is perhaps unsurprising that 81% of respondents planned to increase their focus on risk management, particularly if 'risk' is measured in terms of capital loss. As Lawrence Johansen put it: "Unfortunately, many people interpret risk as volatility or standard deviation and I don't think that is a very good proxy for risk. I think the real proxy for risk is 'am I going to lose capital?' And that is very difficult to manage."



Is governance a better measure of risk and opportunity?

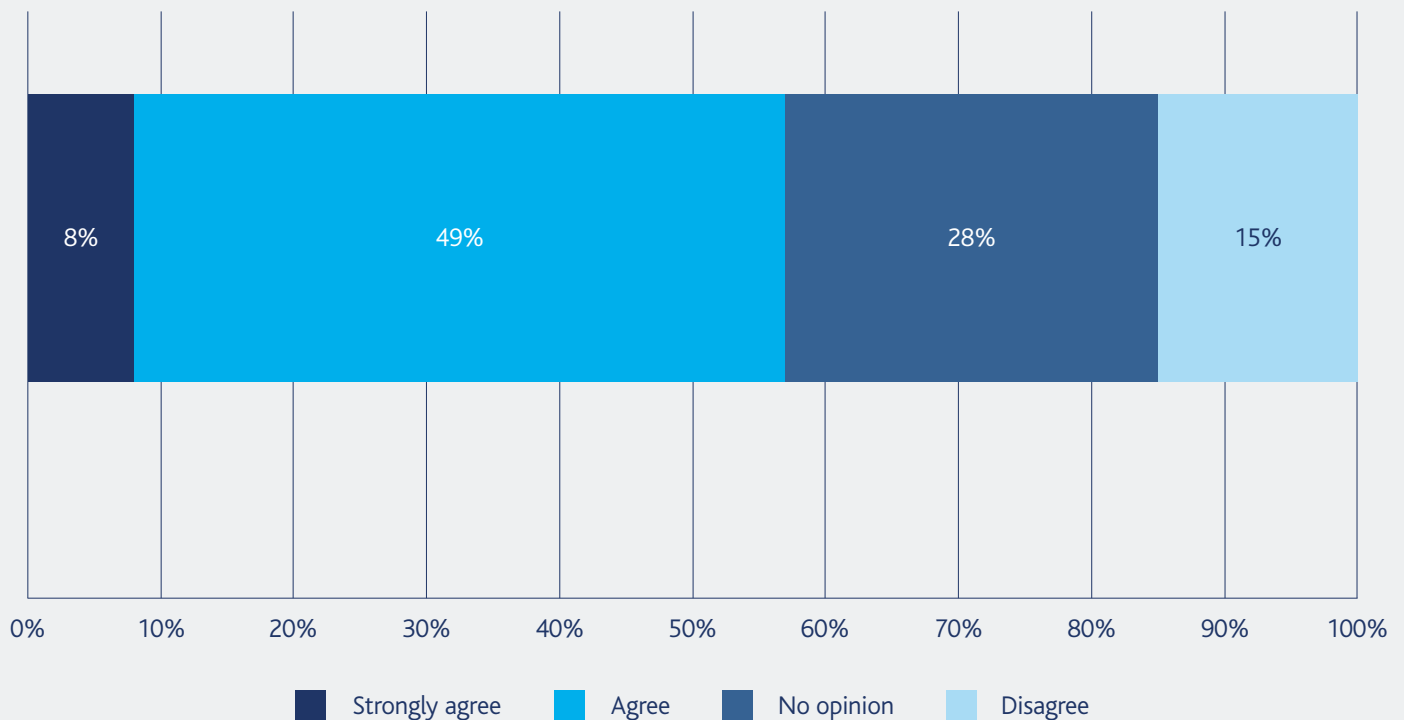
At the same time as the world is experiencing heightened geopolitical uncertainty, the perception of markets and opportunities is also undergoing a profound change.

The distinction between emerging and developed markets has become more difficult to define since the 2008-09 financial crisis. In our research, there was broad agreement that the existing 'emerging' and 'developed' categorisation is inadequate in today's world. 57% of respondents agreed that a country's governance regime and competency is a better measure of risk and opportunity (see Q2).

Nigel Bottom, International Pensions Manager at Motorola Solutions UK Ltd, said: "Research has shown that governance competencies tend to lead to better outcomes for economic growth in particular locations. Governance competence is a better starting point; whilst 'emerged' and 'developed' are relevant, this categorisation is crude and doesn't tell you enough."

Lawrence Johansen agreed: "I think the terms 'developed' and 'developing' or 'emerging' markets are an artificial construct. Given what Europe has gone through with respect to Portugal, Italy, Ireland, Greece and Spain it is hard to suggest that developed countries don't suffer some of the same problems as emerging markets or developing countries."

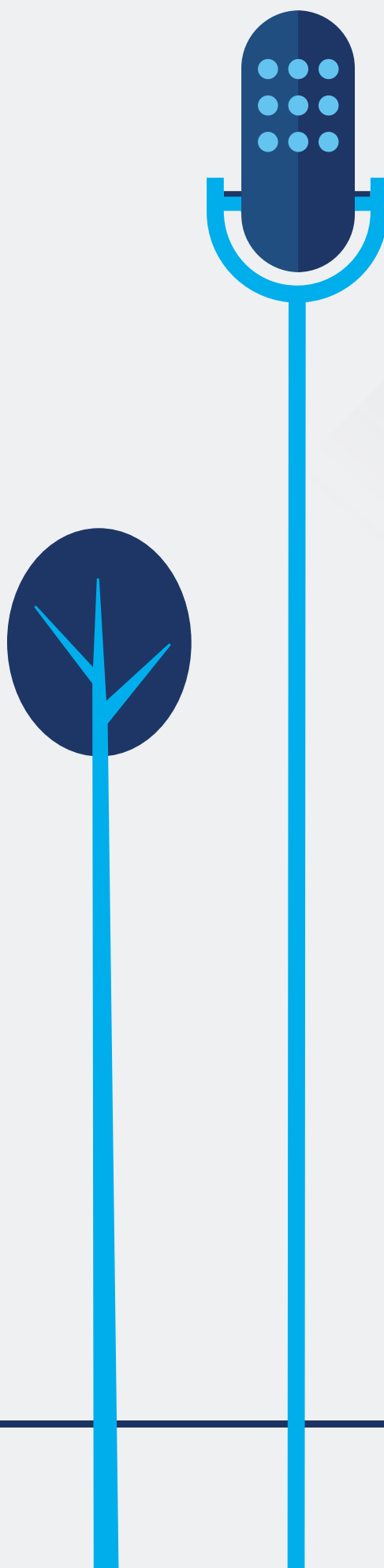
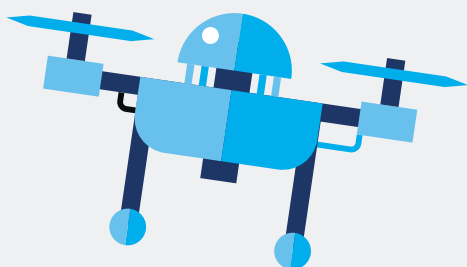
Q2. Is country governance regime/competency a better measure of opportunity/risk than the traditional 'emerging and developed' categories?

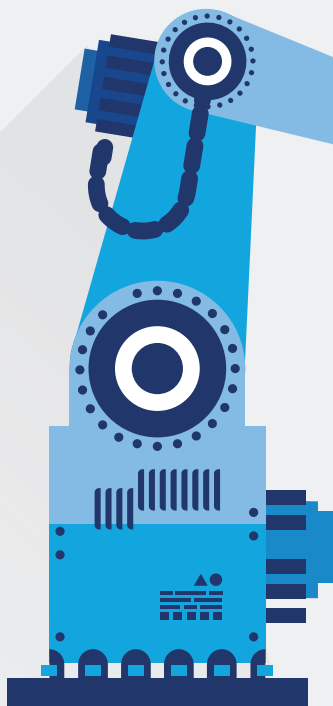


15% of respondents suggested that the 'emerging and developed' categorisation is fit for purpose – if only as a starting point for analysis. "Generally, the emerging/developed categories still hold from both an economic and governance point of view", said David Dickinson, Group Manager, Treasury and Pensions, London Borough of Barking and Dagenham.

The role of governance is clearly fundamental to country-based research and while the traditional emerging/developed categorisation is simple, it is also crude and requires the overlay of a governance competency framework to enable analysts to make truly informed decisions on risks and opportunities. In which case, an acceptable series of metrics needs to be established to measure governance competency in relation to, for instance: education, human rights, capital income, natural resources, healthcare and life expectancy.

Our research found that there is a move underway from country-based analyses as a start point, and an evaluation in terms of developed/emerging markets, towards a more holistic assessment of opportunities. This is certainly the case for Rachel Wood, Pension Fund Investment Strategist, West Sussex County Council (UK): "We've moved away from the emerging versus developed categorisation to having a global appreciation and understanding of the stocks within that global basis on their own merit: the governance and the country's specific circumstances would be considered beneficial or not as part of that analysis. It's not that you've got a predilection to hold lots of emerging market stock; you've got a requirement to hold lots of good stock irrespective."

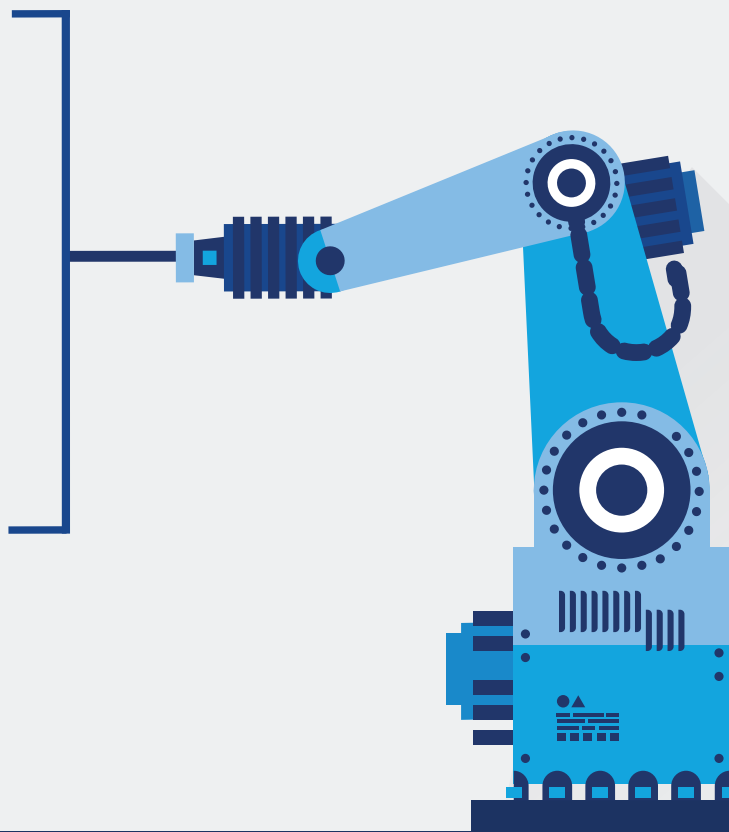




“57% of respondents agreed that a country’s governance regime and competency is a better measure of risk and opportunity”

“It’s not that you’ve got a predilection to hold lots of emerging market stock; you’ve got a requirement to hold lots of good stock irrespective”

*Rachel Wood,
Pension Fund Investment Strategist,
West Sussex County Council*



What actions should asset managers take in relation to country analysis?

There was an implicit understanding among respondents, and an explicit expectation also, that asset managers take account of country governance in their assessment of the factors that influence company governance and, therefore, investment opportunity e.g. policies and processes, transparency, independence, challenge, profitability and growth prospects.

We asked research respondents to what extent they expected asset managers to take account of governance regimes when they undertake country-based investment analysis.

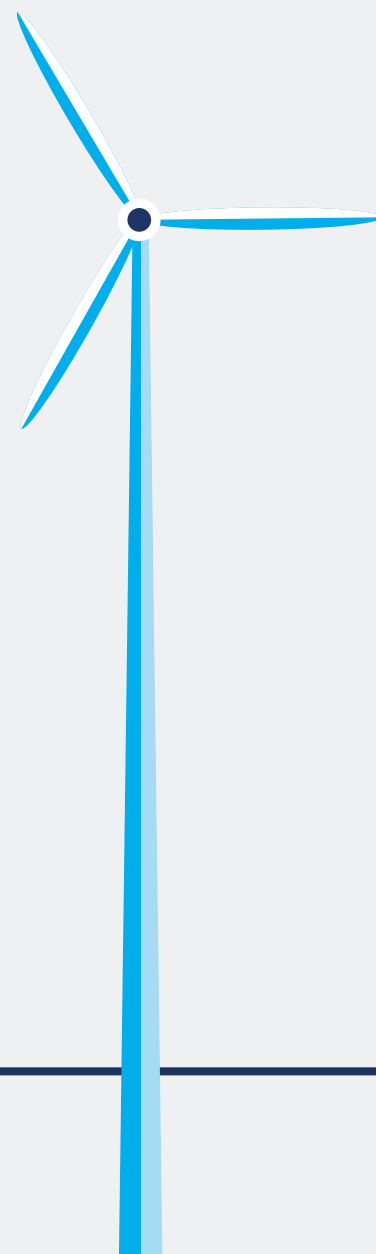
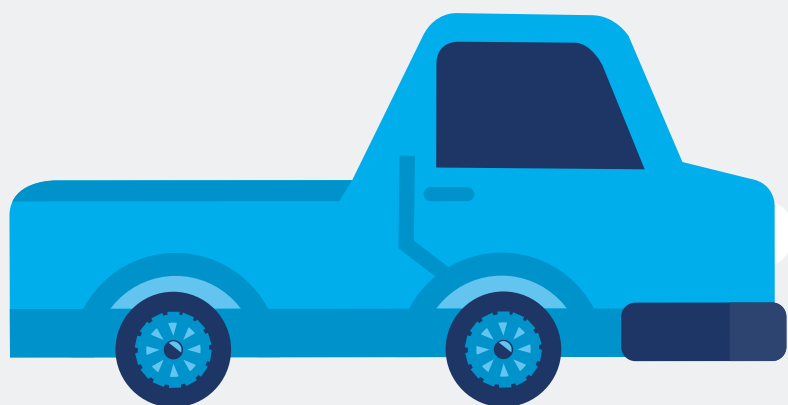
Mark Colman, Head of Fiduciary Management Office, Santander Asset Management said: "Asset managers should certainly include governance in their analysis. Increasingly, it is essential that no matter how good a company is in a particular country, there are times when you've got to say 'do I really want to put my money there?' because there could be issues well beyond the influence of that particular company that should make you shy away from investing."

David Dickinson said: "You would expect fund managers to have a general overall view of where a particular company stands within a country and within an investment asset type. But then, within that, you would need to look individually at the governance they have in place."

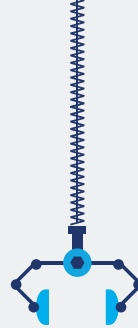
Erik Carleton said: "I expect my asset managers to take account of governance regimes in country-based investment analysis because it is going to affect a cumulative return of capital to shareholders. Things like rule of law in a country, portability of capital, restrictions on investing, money coming in or out, and frictions that may be associated with that in either time or tax, are important."

Michael McCauley, Senior Officer, Investment Programs and Governance, Florida State Board of Administration, USA said: "We have Investment Protection Principles, which are certifications that the asset managers go through. We default governance, accounting quality and, to some extent, geopolitical or climate change loosely under that umbrella but it is not really a hard mandate; once you get to the company level then the governance factors begin to take hold. To me, I don't really think of it as country-based, I think of it more as company-based."

Lawrence Johansen remarked on the greater prominence of governance in recent years: "When I started out four decades ago governance was not at all an issue. It has become extremely important. Even a decade ago nobody worried about proxies and governance outside of the US and the UK and now everybody's governance policy addresses international as well as domestic issues."



From country to company

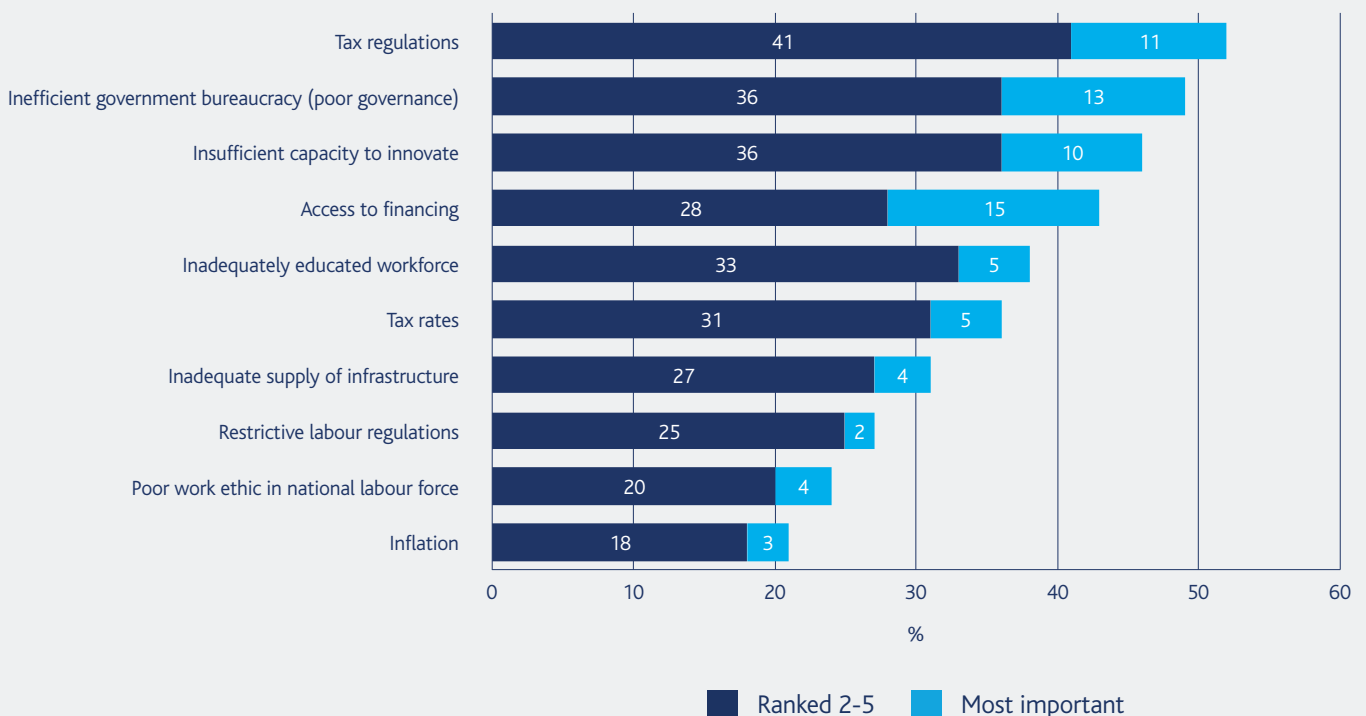


The World Economic Forum Global Competitiveness Report (2015) suggests that the world economy is undergoing significant shifts and supports the argument, confirmed by the findings of our own research, that the traditional distinction between countries being 'developed' or 'emerging' will become less relevant and we will instead differentiate between countries based on whether they are "innovation rich" or "innovation poor."

In addition to evaluating markets in terms of their perceived development and governance competency, recognising the intensifying interplay between geopolitics and economics, we wanted to understand from respondents what they

considered to be the five main challenges facing companies in their geographical area. What might hold them back from becoming the type of organisations they recognise they need to be in today's fast-changing world? Second only to the seemingly perpetual difficulties caused by tax regulations was inadequate government bureaucracy (poor governance). 'Insufficient capacity to innovate' was cited as the third biggest challenge (see Q3).

Q3. From the list below, please rank what you consider to be the five main challenges faced by companies operating in your geographical area



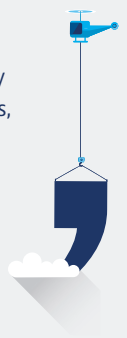
Nigel Bottom remarked: "From a pension point of view there is a whole world of ongoing change which is unhelpful, driven by government wanting tax in one form or another. Having to deal with it creates a lot of inefficiency and expense. It strikes me that there is not just inefficiency with government but the way the government operates which causes inefficiency in the wider economy. Better, clearer, and more consistent decision-making would go a long way towards removing barriers."

Lawrence Johansen said: "Here in the States we joke about the gridlock in Washington and sometimes that's good but generally it's not. Basically, our Federal Reserve has had to do a lot of the 'heavy lifting' because Congress can't get their proverbial act together to do fiscal policy."

One senior professional in the banking sector said: "The biggest threat to banks is trying to understand what technology will bring next. With new technologies the so-called barriers to entry are not there; so we see new competitors coming in, taking market share very quickly, leveraging technology and, indeed, shaking up the market on the back of technology in ways that are completely new and difficult to anticipate."



Commenting on the findings, **Julie Chakraverty, Non-Executive Director at Aberdeen Asset Management and Chairman of the Innovation Committee**, said: "Most companies are organised by business and regional lines. Some have gone further in managing cross-functional processes, for example new product development. The same transformational endeavour must apply to innovation. The pursuit of innovation should be embedded into governance and championed at the highest executive level, so it touches every aspect of the business. At Aberdeen, we believe this approach will not only deliver tangible benefits to our clients, but will also drive our talent strategy and competitive advantage."



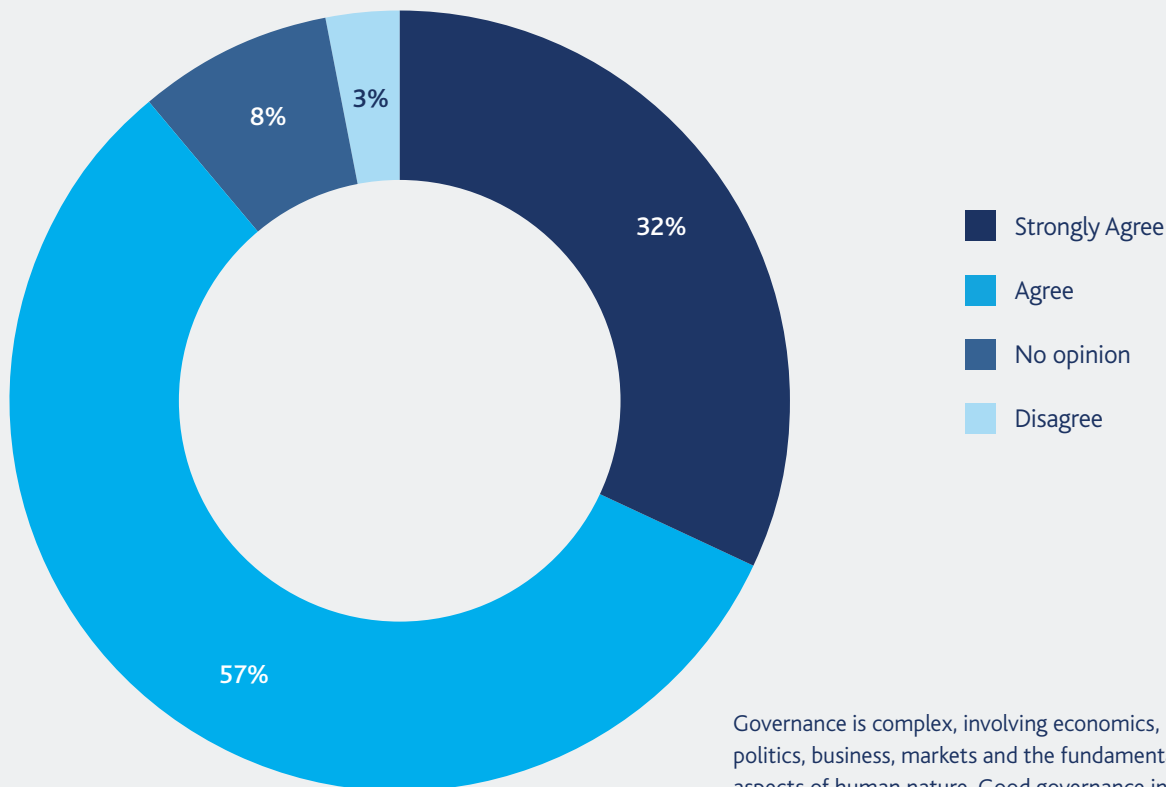
89% of respondents believe effective governance is a critical driver of investment performance

In our research, there was widespread belief that good governance does drive investment performance and that those which do not have good governance procedures in place are likely to fail in the long-term. As one investment professional put it: "If it [good governance] doesn't exist, no matter how attractive it looks, you'd better not go there because very quickly everything can vanish."

Mark Colman said: "Sometimes it can take a while for governance competency to become apparent. It can become apparent by default for instance, by not falling over or having catastrophic events in a way that some of your competitors might. We have seen quite a few examples of banks not having good governance in that sense in the last ten years."



Q4. Is effective governance a critical driver of investment performance?



Devan Kaloo, Head of Equities at Aberdeen Asset Management says:
"The results are unsurprising in regards to good governance being a critical driver of investment performance. At Aberdeen, we firmly believe companies adopting best practices in corporate governance will be more successful in their core activities and deliver enhanced returns to shareholders."

This is why we actively target investment in companies with robust corporate governance practices. To assess this, we strongly believe that there is no substitute for first-hand research which is why our fund managers meet regularly with management and non-executive directors of the companies in which we invest, and exercise continued due diligence outside of these meetings."



Governance is complex, involving economics, politics, business, markets and the fundamental aspects of human nature. Good governance in relation to investment was defined by our respondents in terms of effective;

- management
- clear mandates, strategic direction and clarity of vision
- control and implementation procedures
- succession planning
- talent management and employee remuneration
- embedding of governance principles in the company's culture

and, increasingly, the adoption and integration of environmental, social and governance (ESG) principles in investment decision-making.

One test of good governance was reported as the ability to survive and adapt in times of market stress. Michael McCauley said: "Governance is a very significant and material factor within investment analysis. I always like to think of it as something that is on par with a lot of the other fundamental factors that can drive performance and value. When you look at the company's overall governance profile and you measure it across different underlying dimensions, broadly speaking, it has been shown empirically that governance is a risk mitigant."

Risk management is an essential component of effective governance and the changing face of risk management was also apparent from our research. According to Ernst and Young's global governance, risk and compliance survey, 2015: "Until now, organizations have primarily focused on risks that can be managed through the implementation of controls, but offer little or no upside or benefit. However, with increasing stakeholder demands and an ever-evolving business landscape, leading organizations are now focusing more of their time and effort on managing risks that impact value creation." We asked respondents to rate the relative importance of key strategic risks to their own organisations.

Governance competency and preparedness was ranked as an important priority for our respondents, alongside return on investment in achieving market penetration, and talent management. System innovation and technology were not only perceived as playing an important role in delivering products to markets, but also in delivering effective governance, most notably in relation to the enhancement of management information.

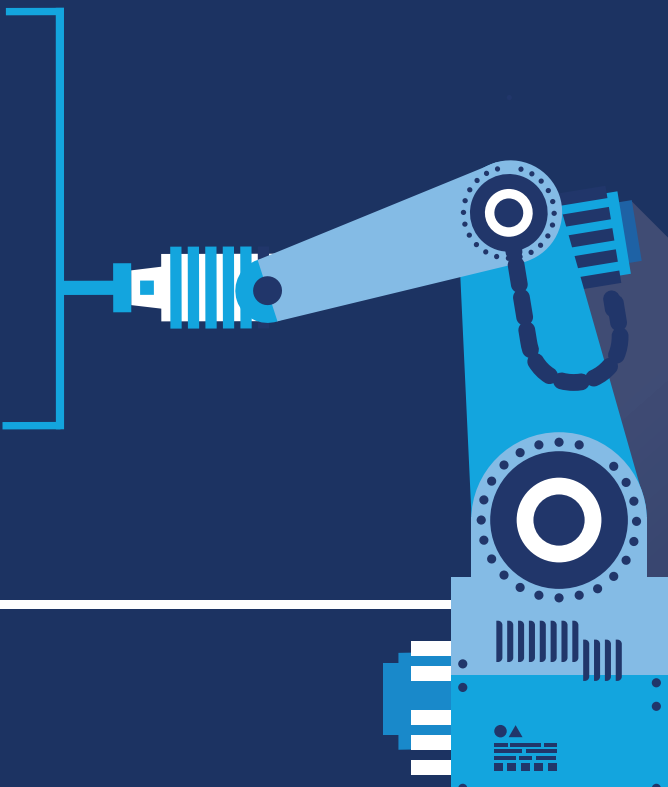
Respondents were clear in their affirmation that a robust, evolving, multi-faceted management information system is essential for the delivery of good governance and adherence to wider ESG principles. "The further you go with the ability to manipulate data, how data feeds at low cost and rapidly, then the better the information flows will be. If your ability to do this is limited and it is expensive and slow, you've got a drag on the information flows for decision-makers. You've got to have good information flows to achieve [good governance] otherwise you will be trying to operate partially blind", said Nigel Bottom.

Management information was viewed as the visible, tangible evidence base for good governance; as one respondent explained: "There is no governance without the right information at the right time and in the right way, without bias and telling the right story."

Governance and stewardship: to what extent should asset managers exert their influence?

We talked to respondents about the difference between governance and stewardship. For some, they were perceived as essentially the same thing. For others, stewardship was considered to be an integral but distinct element of a governance framework, embracing active management, guidance and the opportunity to add value; as one respondent remarked: "Are you just sitting on the side-lines observing what is happening or are you actually providing stewardship, that is, do you have a point of view, can you offer guidance, or have something else to contribute?"

We also asked them what they considered to be the most effective way for asset managers to engage with the companies in which they invest client funds. 85% said that asset managers should engage at the pre-investment due diligence stage and at regular intervals subsequently (see Q5). This does not necessarily mean that asset managers are expected to attend shareholder meetings (only 7% mentioned this).

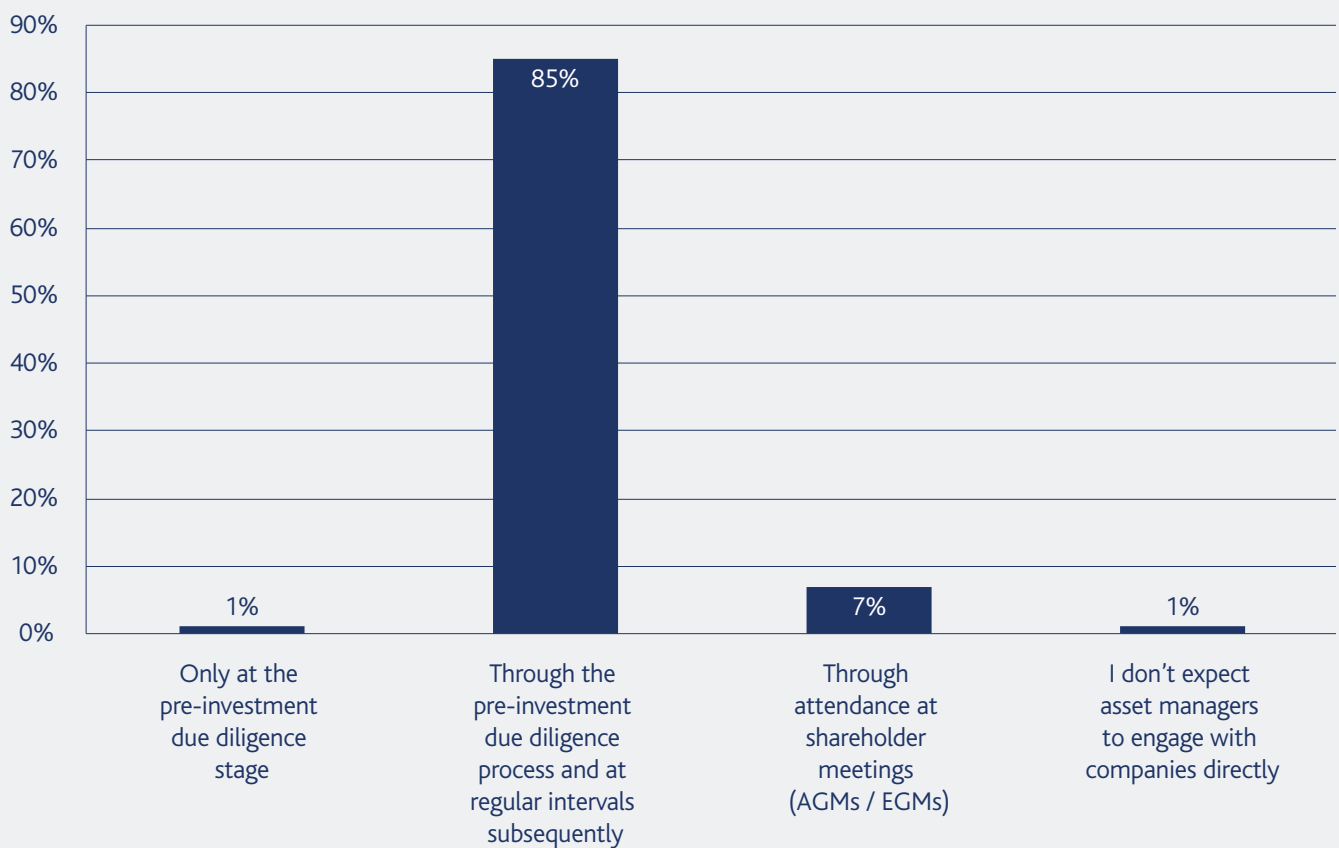


"You've got to have good information flows otherwise you will be trying to operate partially blind."

Nigel Bottom, International Pensions Manager, Motorola Solutions UK Ltd



Q5. What do you think is the most effective way for asset managers to engage with the companies in which they invest client funds?



The frequency with which subsequent engagement is appropriate and effective was viewed very pragmatically in relation to expected outcomes, especially in cases of low-level investments. Nonetheless, regular engagement was considered essential to not only monitor investee companies' standards of governance but also for asset managers themselves to demonstrate best practice in relation to expected outcomes.

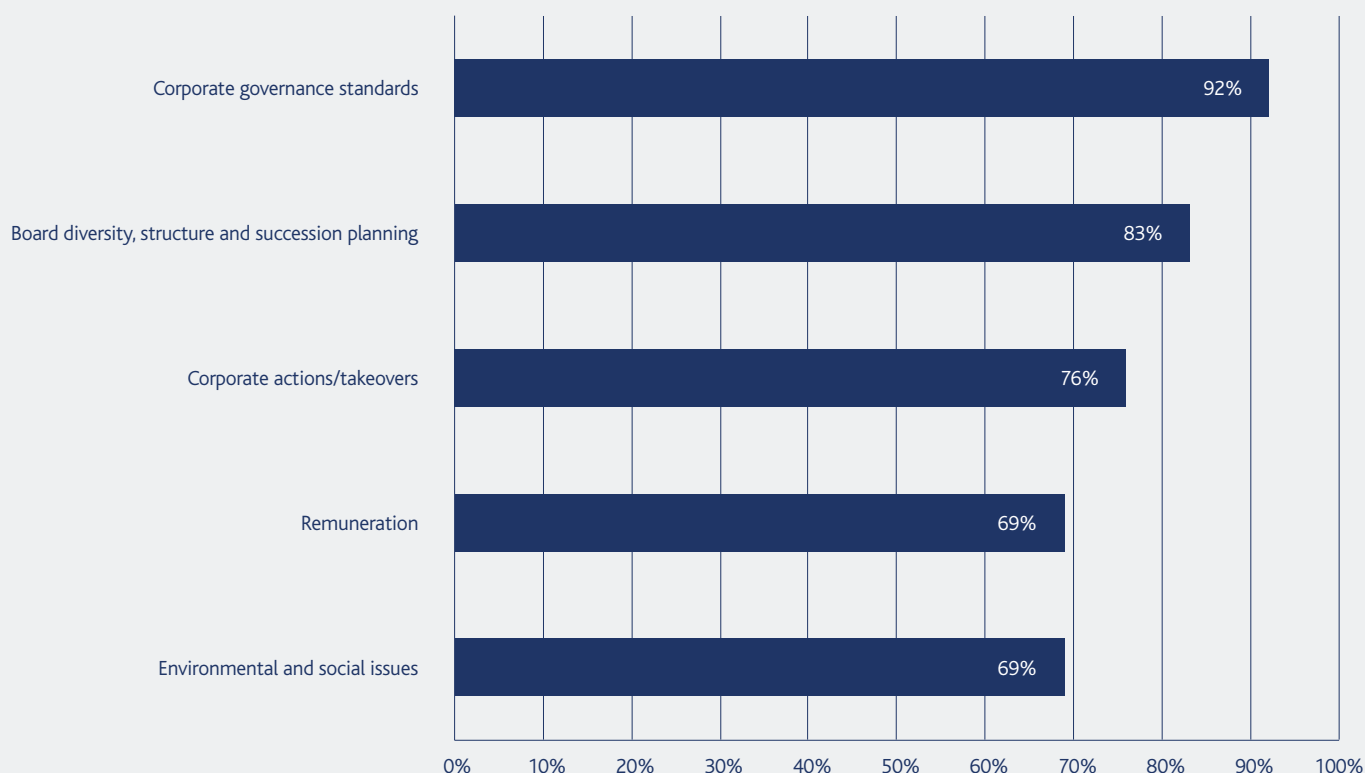
David Dickinson said: "If they've got £3 million invested in Apple then you've got to think, is it worth us even meeting with them because we're not really important? But if you do have quite a significant holding and you can exert some influence then it might be important to meet more regularly. The starting point would be voting; you should always vote. You should have a strong view on a company you're investing in."

Nigel Bottom said: "If you've got a large investment you've got a lot at stake so you should take a closer view. The nature of it would be the bigger driver for me. I don't think shareholder meetings are always appropriate."

In the words of another respondent, "I would expect them to undertake due diligence up front, including visits with the fund managers, then meet with them regularly, to see if there are changes of staff to be investigated or other matters. Normally, there will be a range of factors that would be looked at on a regular basis; the investment consultants are certainly rating those factors and I would expect the asset managers to follow a similar process."

In addition to asking at what stages and how often asset managers should engage with the companies in which they invest client funds, we also asked "on which topics?"

Q6. On which topics should asset managers engage with companies in which they invest client funds?



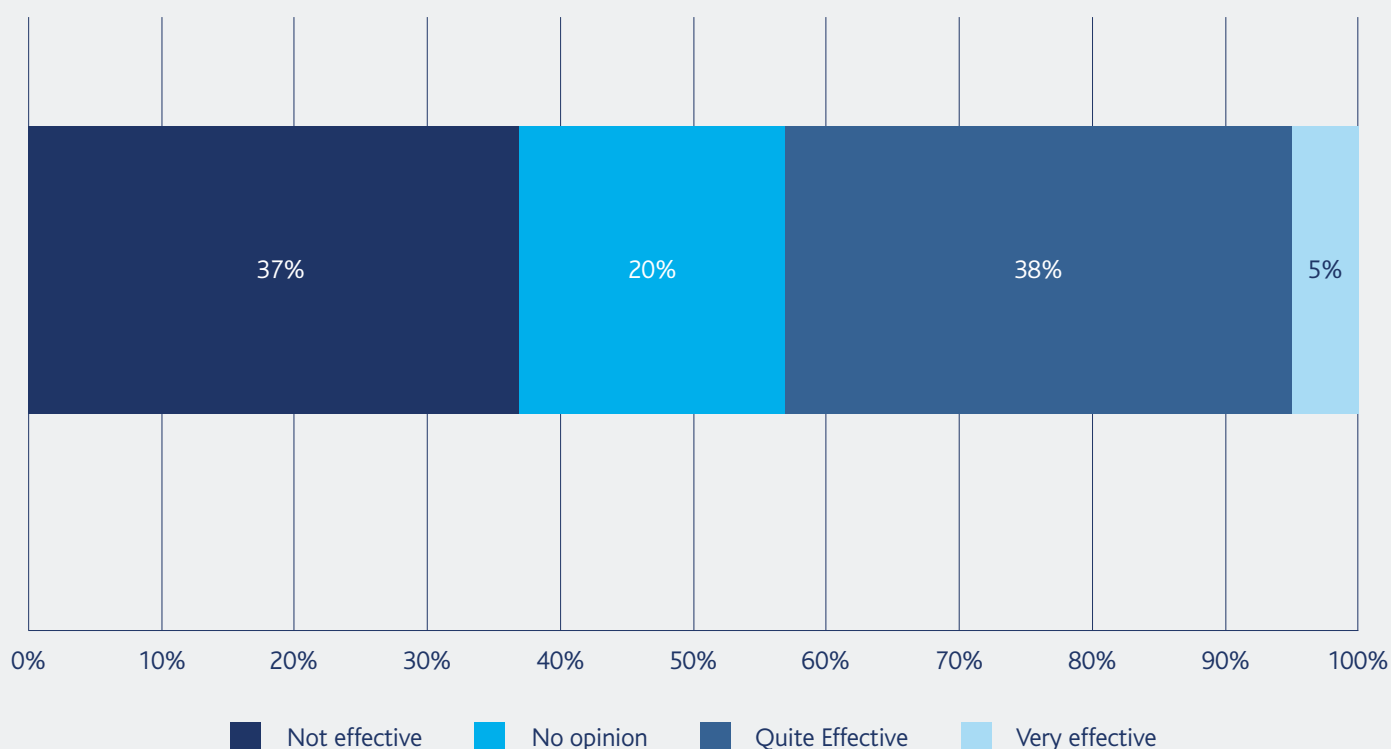
Respondents reported that asset managers should engage with investee companies on a wide range of topics, notably: corporate governance standards (cited by 92% of respondents), board

diversity, structure and succession planning (83%), and corporate actions/takeovers (76%).

Views were polarised on the extent to which asset managers are effective in engaging with the companies in which they invest. 43% of respondents said that their asset managers are effective in this respect. 37% indicated that they are not effective. There was no indication that any sanctions are placed upon those asset managers falling short:

lack of engagement may be rationalised as a difference in investing style, or understanding of the practicalities of regular engagement, or because of the nature and size of investment holdings. Nonetheless, there was clearly something of a gap between expectation and reality in this regard.

Q7. In your experience, how effective are asset managers at engaging with the companies in which they invest?



Overall, respondents in our research believed that asset managers who do engage frequently with their investee companies tend to be more successful than those who do not. Lorelei Watson said: "It varies between them and it varies within them. One of my asset managers has a very good manager; I know he engages fully with companies, goes to see them and gets heavily involved in the management, to good effect."

Paul Lee, Head of Corporate Governance at Aberdeen Asset Management says: "If you view governance as a box-ticking exercise you will not find a link between governance and value. The right governance and stewardship framework is an important pre-requisite to an effective investment approach: seeing a board actively thinking about the issues that matter, and actively engaged in delivering performance over the long term, reinforces confident decision-making. At Aberdeen, we invest for our clients' portfolios in companies globally and actively target investment in those companies with sound corporate governance practices and robust risk management. We know from experience that such companies are much more likely to be successful in their core activities and deliver enhanced returns to shareholders."

The importance and difficulty of long-term investing

The challenge for any long-term investor is tailoring an evaluation scheme that balances short-term rewards, measurement and accountability with the organisation's long-term goals. People tend to discount long-term gain but are highly averse to short-term loss.⁷

Our research began by looking at country risks and trends, the challenges and opportunities that impact investors at company level, and finally at investment challenges. Numerous studies indicate that long-horizon investing is valuable to both investors and society at large. However, there remains a significant gap to be bridged between aspiration and reality.

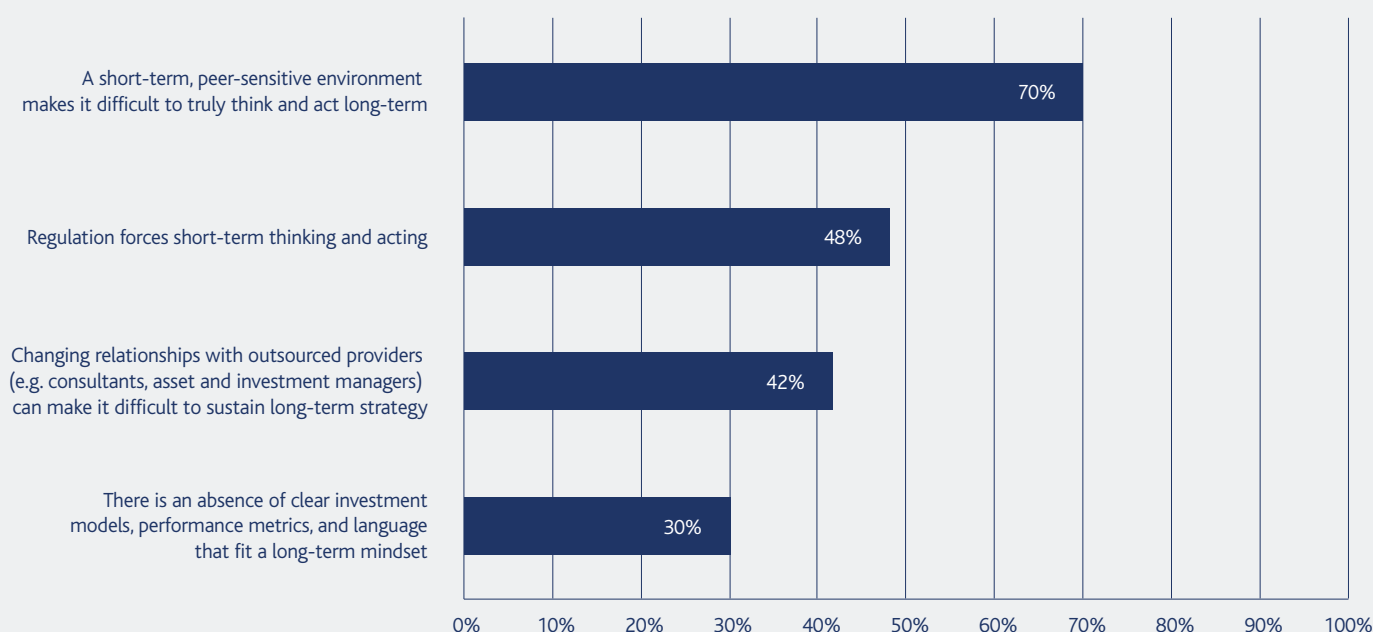
The World Economic Forum report: Measurement, Governance and Long-term Investing (2012), explored how difficulties faced by long-term investors in measuring investment values and returns, risks and liabilities intersect with the governance of long-term investors themselves. The report argues that, without effective governance, measurement schemes can distort decision-making around which investments are chosen and the time frame

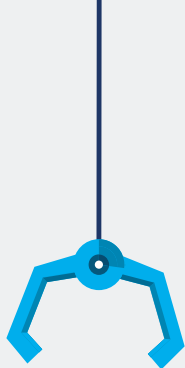
over which they are held. Yet the lack of meaningful, intuitive measurements for performance and risk over long time horizons adds more complexity to long-term investing and the governance of such efforts. It says: "The challenge for any long-term investor is tailoring an evaluation scheme that balances short-term rewards, measurement and accountability with the organisation's long-term goals."

Convincing investors to make genuinely long-term investments can be difficult; it is human nature to want to see results quickly. Furthermore, as the report goes on to say: "People tend to discount long-term gain but are highly averse to short-term loss."

We asked respondents what they considered to be the barriers to putting long-term investing into practice. As the chart below shows, most perceive the main barrier to be a short-term, peer-sensitive environment, which makes it difficult to truly think and act long term.

Q8. Which of the following, if any, do you believe are barriers to putting long-term investing into practice?





Underlying factors for these were reported as:

- **A tendency to compare performance with peer performance or benchmarks**

"We are all comparing ourselves to each other. We've got our own benchmarks but we still compare ourselves to every other local government pension fund", said Lorelei Watson.

- **An imperative to deliver results within short-term tenures**

"Everyone is judged on their results and in investment, especially in relation to manager skill and to be very sure of your decision, you need to take a long-term view – five to ten years – and most people don't have that luxury. It is rare for someone to have a three-year record and to be able to say, 'Well, it's only three years, it's meaningless at this point. Let's wait another three years and then consider it.' It just doesn't happen."

- **In the case of pension schemes, conflicting objectives in the corporate sponsor/trustee relationship**

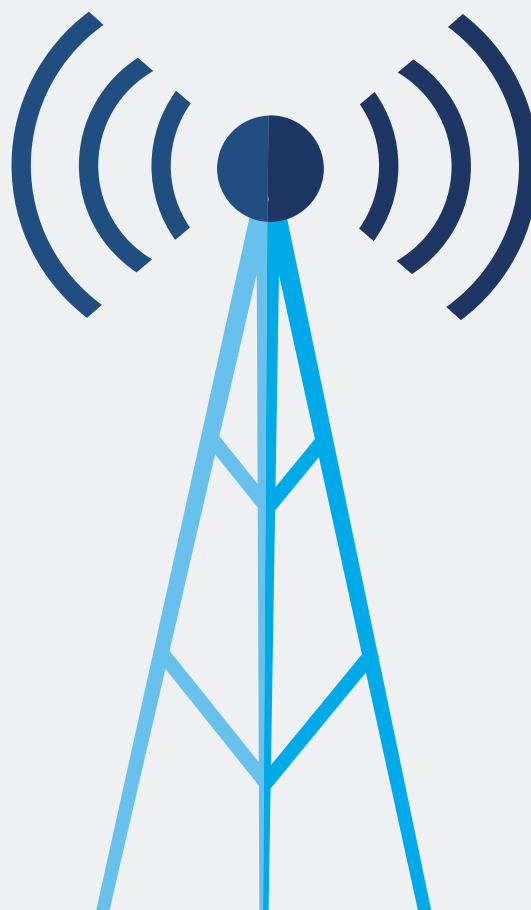
As one respondent put it, "If there is a lot of change in the ownership it can have a dramatic impact on the ability to think longer term. There are some actions that you might want to take to de-risk the scheme but it has an implication in terms of whether or not the sponsoring employer can afford to meet higher contributions if they're required."

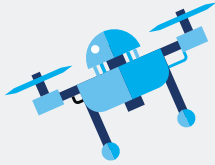


Action clearly lags behind good intention:

"We live in a world where everybody looks at how competitors or peers are doing. That influences decision-making because there is a concern about falling behind your peers – it is more difficult to make bold decisions even if that might be best for the long term", said Nigel Bottom.

Tom Berger, Chief Investment Officer at Equitable Life Assurance Society said: "If you hire an investment manager it is very human to want to evaluate them over a short period despite the fact that we are all taught by the experts to do so over a period of at least three years, probably more. Short-termism is part of the culture of the investment management community and probably indicates a lack of knowledge among some practitioners that it is difficult to differentiate investment skill over luck over short periods."





48% of respondents agreed that regulation forces short-term thinking and acting, particularly in relation to the three-yearly valuation process for pension schemes. Chris Gilbert, Pensions Manager, Dover Harbour Board Pension and Life Assurance Scheme (UK), said: "Almost inevitably it is a snapshot and that requires short-term thinking because if you've got a huge deficit, obviously the employer has to fund that deficit."

Mark Colman agreed that this was the case "particularly in the way pension funds are valued under accounting standards. It doesn't necessarily always force short-term thinking and action but it can result in distorted choices – and that can mean short-term thinking and acting."

42% of respondents recognised that changing relationships with investment providers and advisers can make it difficult to sustain long-term strategy, due to short-termism on the part of fund managers, including incentives to perform. David Dickinson said: "Short term incentives within fund managers have always been a problem. Generally, if your strategy is to invest long term, providing you are happy with the assets that are being invested and you diversify sufficiently, then both parties should be happy. But sometimes fund managers think they've got say five years to make their mark and then move on, whereas others who have been in post for 20-25 years do seem to have a better perspective."

Rachel Wood said: "I think it is well known that changing your investment manager undermines your performance if you do it at the wrong time."

Respondents pointed out that it is not just changes in the outsourced relationships which cause disruption in performance; in the case of pension schemes, changes in personnel within the trustee board and lack of continuity with the corporate sponsor are also highly disruptive: "Where the chairman or an influential member of the trustees retires, or moves on, the new incumbent isn't generally happy to wait five years to see how the process of the strategy that has just been put in place will turn out."

"A lack of continuity within a trustee board or lack of continuity with a sponsoring employer is more likely to make it difficult. With outsourced providers, after a period of integration, you can usually get back on track and actually it is quite healthy having a fresh point of view."

The vast majority of respondents believed that there were sufficient investment models and performance metrics available. Indeed, one factor identified as promoting short-termism was the proliferation of models and metrics. "The problem is there are too many models, metrics and too much language around performance – we don't need more, we need less. The trend is towards trustees being able to look up and see almost in real time how their assets are doing: more disclosure, more transparency around performance, which makes it harder."

Among the other barriers to long-term investing cited were: external pressures from the media and government; political agendas and government timeframes; and the lack of access to very long-term investment structures.



Commenting on the research findings, **Anne Richards, Chief Investment Officer at Aberdeen**, said: "The 2008-2009 financial crisis demonstrated the disastrous consequences of a short-term mentality in markets. Since then, the importance of a long-term view has been widely recognised; Professor John Kay and Sir George Cox both produced reports that highlighted the need to replace short-termism with long-term thinking in markets. Yet as this research identified, short-termism is very difficult to uproot because it isn't a policy but a culture, which must be embedded at both a company and industry-wide level.

At Aberdeen, our worldwide approach to investment is to think of ourselves as long-term owners of the business rather than short-term tenants of the shares: we resist the temptation to focus on 'market noise' and focus on each investment as if we were buying the entire company, making a long-term commitment to it. Ultimately, share prices reflect the underlying business fundamentals; our time horizon is aligned with those of the companies in which we invest, not with market trends. Governance and stewardship are pivotal to this approach."



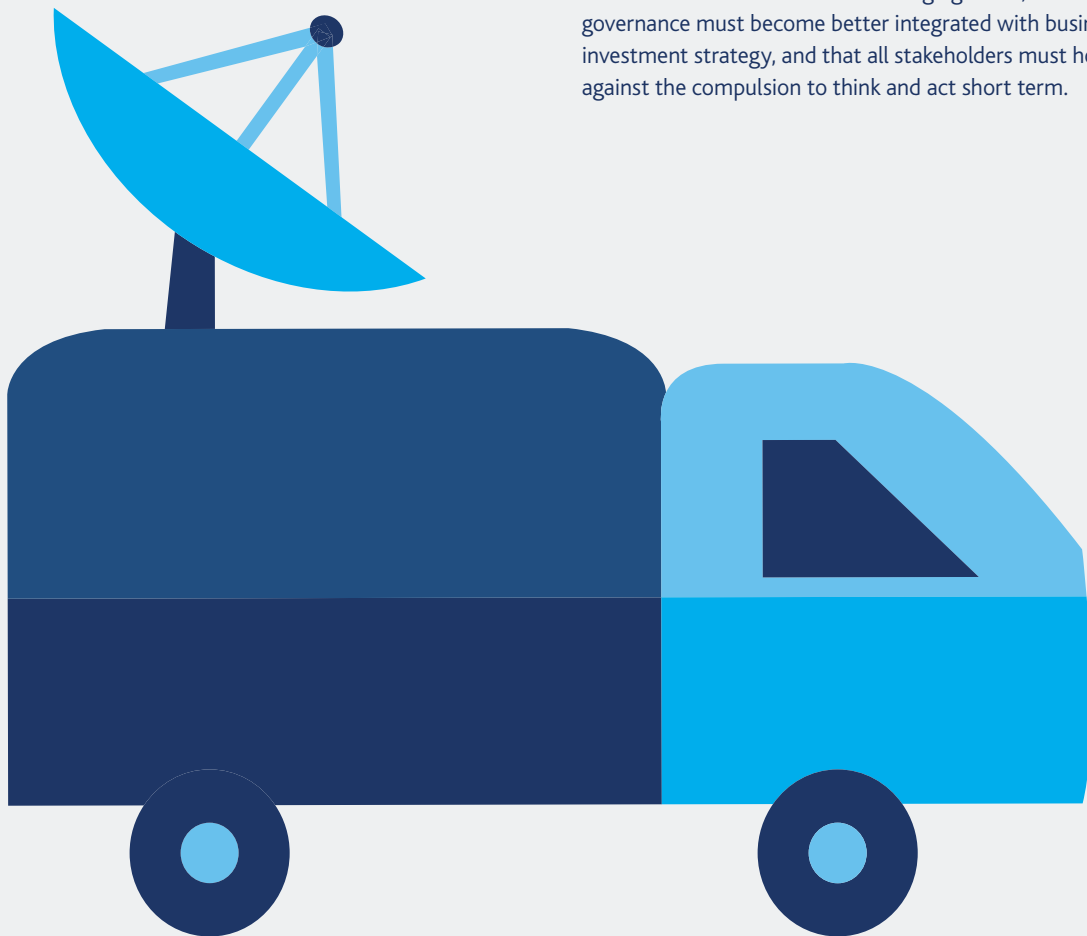
Conclusion: governance needs to come alive

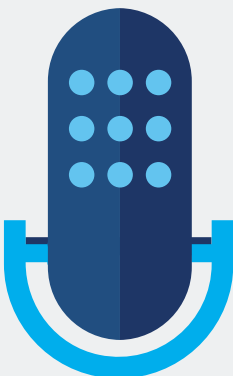
What should good governance look like? According to our research, it must be more than a robust framework and a set of policies and procedures. It must equate to a 'living, breathing' process; one that is dynamic and where relationship management plays a leading part. Country, company and investment governance can clearly benefit from improvements in technology, communications and management information but will only ever be effective if these tools are used in conjunction with oversight from experienced personnel who possess the skills to make good decisions; who can not only anticipate risk, but also have the ability to recognise opportunity to add value.

Our research found that investors are, albeit slowly, moving from an approach where risk management is focused less on external risks that cannot be controlled, to managing risks that impact value creation, but feel constrained by persistent regulatory change, limited resources and insufficient capacity

to innovate. Breaking free from these constraints altogether might never be entirely feasible but positive change towards a more dynamic utilisation of governance (ultimately towards better, more meaningful outcomes) is unlikely to happen without both a 'top down' and 'bottom up' effort on the part of management.

The respondents who took part in this research were admirably committed to embracing new ideas, cognisant of how governance needs to work in today's world and what is required to implement good governance, but they need the support of their industry colleagues, regulators, policymakers and their investment providers, in order to be effective. As global investors, they face very real threats in the form of geopolitical unrest and the downsides of globalisation. On a day to day basis, they know that they need to focus on the long term, but for many reasons outside their control, despite this being in the long-term interests of their organisation and beneficiaries, it is often extremely difficult. They understand that new risks mean that new rules are needed. In a changing world, this means that governance must become better integrated with business and investment strategy, and that all stakeholders must hold firm against the compulsion to think and act short term.





Aberdeen's approach

An active, dynamic process clearly focused on driving value

Good corporate governance is at the heart of Aberdeen's business: we are actively committed to implementing robust policies and practices. As a global asset manager, connectivity and teamwork are especially important to us, to ensure that everything we do is executed to the same high standards around the world. We maintain and promote these standards through disciplined management, local decision-making and a team-based approach.

Corporate Governance Principles

The Aberdeen Corporate Governance Principles provide a framework for investment analysis, engagement and proxy voting for investee companies worldwide. We invest for our clients' portfolios in companies globally and actively target investment in those companies with sound corporate governance practices and robust risk management.

Approach to stewardship

Our statement setting out our commitment to delivering the aims of the world's Stewardship Codes brings the Corporate Governance Principles to life and closely links them with our investment decisions and ongoing ownership on behalf of clients. Aberdeen is committed to exercising responsible ownership with a conviction that companies adopting best practices in corporate governance and risk management will be more successful in their core activities and deliver enhanced returns to shareholders.

Engagement

As long-term owners of companies on behalf of our clients, we regard the process of stewardship as a natural part of our investment approach. Our fund managers regularly meet with the management and non-executive directors of companies in which we actively invest, and we also seek to mirror this approach across our other portfolios.

Proxy voting

Aberdeen endeavours to exercise proxy votes at all shareholder meetings where authorised to do so by clients. We periodically report on our proxy voting decisions, engagement activities and findings. At companies where we have an active investment, voting decisions are led by our investment managers.



Acknowledgements

Amit Bisaria

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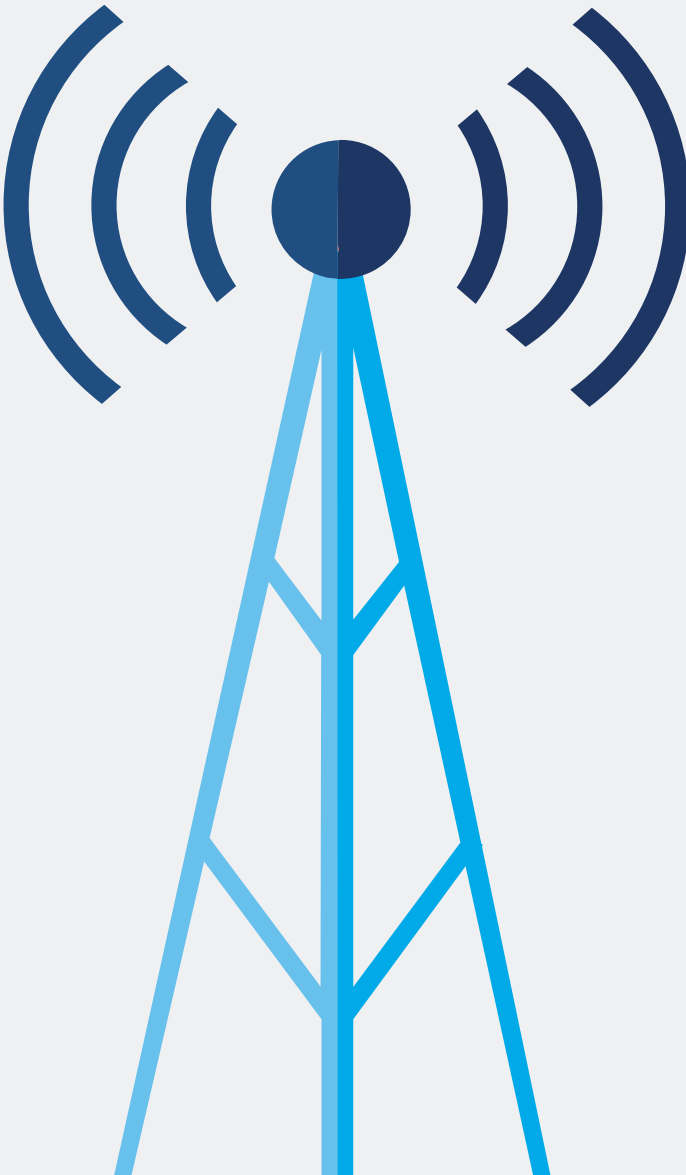
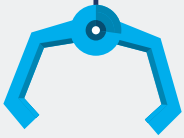
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