In the UK, both public and private sector funds are more engaged in pragmatic investor activism as compared to the US, as they do not face the same conflicts of interests. Unlike in the US, British pension fund trustees are legally independent, and are not an extension of the CFO’s office. Dialogues between shareholders and firms take place in the context of the ‘nuclear option’, the right of shareholders of calling an extraordinary general meeting within three weeks with 10 per cent of the votes.

From an academic perspective, the link between good corporate governance and firm performance is not strong. However, there is a growing body of literature from market-oriented institutions demonstrating that good governance structures outperform bad ones. For example, a recent study by Professor Lawrence Brown of Georgia State University, sponsored by Institutional Investor Services, found that firms with poor governance structures in the US have lower returns over 3-, 5- and 10-year periods, than comparable firms with good governance structures.26 Deutsche Bank has conducted research on the same topic in Europe with similar conclusions.

From Alastair Ross Goobey’s career experience, he is convinced that good governance matters, even if it cannot be proved to the satisfaction of many academics. Over his career as an institutional investor, he has witnessed positive changes in corporate governance in the UK, particularly from the 1970s onward with the introduction of professional non-executive directors on boards replacing traditional appointees such as aristocrats, generals and admirals.
Hermes Focus Fund and shareholder activism in the UK

Ross Goobey has spent his career as an institutional investor in the UK and managed one of its largest institutions, Hermes, the manager of the British Telecom (BT) and much of the Royal Mail pension schemes, which own approximately 1.5 per cent of the UK equity market and manages £50 billion. The size of its holdings often meant that it could not just proceed with a quiet exit from firms with governance problems. Having taken a more activist stance for a number of years, a separate Hermes Focus Fund was set up in 1998 as a purely activist fund with a strong emphasis on corporate governance. The fund management business is 100 per cent owned by the BT pension fund to insulate it from external pressures. However, the Funds (a UK large cap, a UK small cap and a continental European Fund) have also attracted substantial third-party commitments from both the public and private sectors across the world, who view them as a means of fulfilling their fiduciary responsibilities.

Hermes Focus itself invests in underperforming firms with a view to changing the governance structure (or elements of it such as the board, management or strategy), and/or capital structure of the firm concerned. Hermes employs approximately 50 people focusing on corporate governance issues, 10 times more than any other fund in the UK. The skill sets of its employees are often completely different from most fund managers, and it is a very labour-intensive business requiring substantial expertise and investment. Taking this into account – on top of the conflicts of interest that most large financial services organisations face in this area – activism can be very problematic.

Hermes corporate governance-focused investment process

When Hermes Focus has identified an undervalued firm, it analyses the soundness of the underlying business to decide whether there is a value creation opportunity by changing the governance structure. If there is, Hermes will approach the executive management and talk to them about their views on the firm’s strategy. Sometimes the management are willing to engage the fund in dialogue. However, if they do not progress with the management, they then will approach the chairman and non-executive directors. Hermes makes it very