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Purpose, Culture and Long-Term Value — Not Just a Headline

KEY TAKEAWAYS

- Recent letters from two of the world's largest long-term "passive" investors provide a powerful counterpoint to the seemingly never-ending short-term oriented agitation from activist hedge funds.
- These long-term investors believe that purpose and profit are "inextricably linked" and seek to elevate "value" (not "values") in support of long-termism over short-termism.
- Index fund managers can either be powerful allies in promoting and protecting long-term shareholder value or at-risk "swing votes" in a proxy contest.
- Effective "off-season" engagement should be a strategic priority.

Public company CEOs and directors have a new pen pal. Adding to Larry Fink's annual letter to CEOs, this year Cyrus Taraporevala, State Street's new CEO, sent his own letter encouraging boards to focus on aligning corporate culture and strategy as a driver of long-term, sustainable shareholder value.

These letters from two of the world's largest long-term "passive" investors offer a powerful counterpoint to the seemingly never-ending short-term oriented agitation from activist hedge funds. As capital continues to flow from actively managed strategies into passive index funds, BlackRock, State Street and Vanguard — the three largest "passive" managers — now control approximately 20 percent of the value of the S&P 500 and collectively constitute the single largest shareholder in almost 90 percent of S&P 500 firms. And because they generally may not sell their shares when a company underperforms (or buy more when it outperforms), they view themselves as permanent capital focused on the long term.

From this position of strength, these asset managers are pushing companies to take actions that benefit the interests of long-term shareholders through emphasis on purpose, culture and other intangibles — concepts that have not traditionally been measured or discussed with investors. Both BlackRock and State Street make it abundantly clear that their goal is not philanthropy but rather to promote principles and practices that support a long-term outlook rather than a narrow focus on short-term financial results. They believe that purpose and profit are "inextricably linked" and seek to elevate "value" (not "values") in support of long-termism over short-termism.

Directors and senior management should be prepared to engage with and actively address the priorities of this increasingly vocal and powerful asset class, and to that end, should consider the following:

- **Ignore Passives at your Peril.** Index fund managers can either be powerful allies in promoting and protecting long-term shareholder value or at-risk "swing votes" in a proxy contest, where the big three index funds support activists on average more than 25 percent of the time. Activists are already spending significant time with index funds and other large institutions, including during the "off-season," engaging on environmental, social and governance ("ESG") matters, making it all the more important for companies to be doing the same.
- **Align Strategy and ESG.** Developing and articulating your strategic, long-term vision and identifying the intangible value creators that actually matter to your company, its stakeholders and its industry will be important tools for shareholder engagement. Long-term investors expect management and directors alike to be familiar with, and be prepared to discuss, how the company's approach on both strategy and ESG topics are aligned, including with respect to corporate governance, human capital, compensation and the long-term risk of regulation or industry change. For example, State Street expects that directors ensure that corporate culture aligns with strategy, and through engagement they expect directors to articulate their company's culture and demonstrate how they assess, monitor and influence change to culture when needed.
- **Refresh Disclosure.** Investor communications materials and SEC disclosure should be evaluated with a fresh eye to ensure that the company's strategic direction and business case, as well as risk factors and challenges, are clear to investors and match current strategic priorities, culture and purpose. Long-term investors also expect these materials to address ESG factors that are material to the company's ability to generate positive returns for investors over the long run rather than merely highlighting notoriously unreliable ESG rankings. The emphasis should be on substance, not decoration.

If you have any questions about the matters addressed in this *Kirkland Governance Update*, please contact the following Kirkland attorneys or your regular Kirkland contact.

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