



The Hermes Principles

What shareholders expect of public companies –
and what companies should expect of their investors



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The aims of this document

Hermes believes that companies perform better where there is understanding between them and their owners. A company is a joint enterprise between those that run it – its directors and managers – and those that own it – its shareholders. Investments in public companies are more likely to succeed if investors communicate reasonable expectations properly and corporations better understand what is being asked of them.

Hermes would like to thank the senior business figures who contributed their comments in the writing of this document.

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The Hermes Principles

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Introduction

Hermes Governance Code

www.hermes.co.uk/pdf/corporate_governance/hermes_principles.pdf

This document sets out principles to address a simple question: 'What should owners expect from UK public companies and what should these companies expect from their owners?'

Its aim is to create a common understanding, between managers and owners, of the proper goals of a public company.

It sets out a number of expectations which Hermes believes should exist between owners and managers. By being explicit about appropriate expectations, we aim to get a better framework for communication and dialogue between boards and shareholders, and so help boards manage their companies better.

The ultimate goal of the company is to create wealth for its shareholders. This in turn suggests a number of actions which it is reasonable for shareholders to expect of companies.

The expectations in this document are derived from Hermes' extensive experience as an active and engaged shareholder on behalf of its pension fund clients (throughout this document reference to Hermes as shareholder is in recognition of Hermes as the agent for the owners). Hermes invests in some of the best companies, that already deliver shareholder value according to these principles. We also intervene in companies which have not delivered shareholder value.

This experience, together with that of similar funds around the world with whom Hermes has close relationships, has provided a number of lessons about why companies often fail in their primary goal of delivering long-term value. Our joint experience, of achieving outperformance on those investments where intervention has altered corporate behaviour, suggests there are good central management disciplines which will greatly increase the likelihood of value delivery. It is important that, as investors, we are explicit about the importance we place on these disciplines.

We are not seeking to place new burdens on businesses. It is not in our interest as investors to do that. What we might expect as one outcome of this document is some reappraisal of the way that businesses communicate with shareholders.

These principles are complementary to Hermes' position on corporate governance. Governance sets out the structures and processes by which a company should be controlled through its board. It should encourage positive entrepreneurial behaviour, while having appropriate checks and balances through its independent directors and the right balance of power to ensure decisions are wisely made. We monitor the governance of the companies in which we invest on behalf of our clients closely, giving support to those which demonstrate an appropriate structure, and intervening to change those which do not.

So far Hermes (and indeed all other fund managers) have been less explicit in addressing the question of the management implications of accepting the goal of value creation. This document aims to fill that gap. We would be pleased to discuss these principles with the managers of public companies, other shareholders and any other interested parties to create the greatest possible clarity about our expectations.

We believe these principles have significant implications. We would like to replace the damaging finger-pointing which has characterised the City-Industry debate in the past, with a positive dialogue between managers and owners about the proper purpose of the corporation.

Responsible behaviour by boards requires responsible investors. A company that is demonstrating commitment to delivering long-term shareholder value should expect ongoing support from its shareholders. At Hermes, we aim to give enduring support to companies which demonstrate such a commitment. ■

At Hermes we aim to give enduring support to companies which demonstrate commitment to long-term shareholder value

Investment principles

The shareholders' interest is the objective of the company

Those who control the largest blocks of shares in the UK, are the investment 'institutions'. The ultimate beneficiaries of most institutional investment activity are those who hold pensions and life insurance policies. In Hermes' case, several million people depend on our investment to secure their income in old age. Hermes' clients have liabilities which extend for a long period of time. A typical 'average' liability would be well over a quarter of a century. It is these liabilities that we seek to cover by investing in and becoming the part-owners of public companies.

The interests of shareholders are not delivered by formal contract, as the interests of bond holders, consumers, or even employees are. The shareholders' interest is the objective of the company. The definition and implications of this interest is the aim of this document. We hold it as axiomatic that the primary goal of a UK listed company is to be run in the long-term interests of its shareholders – to generate value for them.

Central to this goal is the need to create a financial surplus.

For long-term value creation, it is essential that companies create a financial surplus in excess of their cost of capital. It is that surplus which pays for pensions and insurance policies. Growth, earnings per share, return on capital employed and market share measure the ways that surplus is created, but are not surrogate measures for the financial surplus itself. It is possible to demonstrate earnings-per-share growth while destroying shareholder value.

Financial surplus is achieved by having a competitive advantage.

Given the lengthy timeframe for realising the returns on projects and the uncertainty under which most business decisions are made, companies need to be

able to demonstrate that their investment decisions are soundly based. A company should be able to demonstrate its competitive advantage, both at corporate and at business unit level.

And in so doing it should demonstrate ethical behaviour.

As a long-term diversified investor, we oppose companies behaving in a way which knowingly passes costs on to other companies or to the tax payer, and as such is socially or environmentally unacceptable, or unethical. It makes no sense if business success is achieved by creating other costs ('externalising costs') which the beneficial owners of companies will ultimately pay for.

In summary, a company's primary consideration should be the generation of long-term shareholder value, and this should be based on appropriate financial disciplines, competitive advantage, and within a framework which is economically, ethically and socially responsible and sustainable.

Hermes believes these goals should be shared by other long-term investors such as pension funds and life insurance companies. In our experience many managers tell us that their discussions with the investment community rarely focus on these issues. They ask how a company can be expected to show absolute commitment to long-term shareholder value when the majority of its investors fail to demonstrate adequately that this is what they require, or express whether they consider the company – as seen from their perspective – is achieving it. Some of these issues can be better understood by thinking about the behaviour of the capital markets. ■

'Several million people depend on Hermes' investments to secure their income in old age.'



Capital market behaviour

Much discussion between companies and shareholders is about helping investors to decide if, over the short run, a company's shares are likely to rise or fall. This will usually be based on some concept of over or undervaluation, often over a short time period. Therefore companies may feel investors have an obsessional concern with short-term performance. Often they are correct. Fund managers wish to understand short-term performance so that they can exploit relatively short-term movements in the share price and hence outperform their peers in a relative sense. This attention to relative performance is one of the key factors in assessment of fund managers themselves, yet pension fund or insurance liabilities are met out of absolute returns over the long term, not relative ones in the short term.

The principal way in which fund managers seek to outperform each other is through buying and selling company shares. If a fund manager judges that the company's shares seem overpriced by the market relative to its future prospects, they will sell or maintain the option to sell the shares, and vice-versa if it is underpriced. Trading in company shares does have a value. It keeps the market 'liquid', allowing funds to assess the value of their assets properly, and can be a signal to management of performance issues.

Because this trading activity implicitly dominates both performance measurement and information supply in the investment industry, it can also dominate the discussions between shareholders and the companies in which they invest, particularly when brokers themselves also seek to be intermediaries between investors and companies. The best companies ensure that they have a proper dialogue with their investors directly, not just through intermediaries. However, too many companies focus investor relations activities on brokers and analysts, rather than on those actually investing.

A large infrastructure of information sources and opinion supports this trading activity. The commission brokers receive on trading shares is the prime source of their income. Most brokers' reports on companies, will be headed 'buy', 'sell' or some other trading recommendation.

As we have said, there is nothing wrong with this trading activity in itself. What can cause problems is if the attention given to short-term performance distracts company managers from the goal of creating long-term shareholder value. If there are some participants in the market who seek to bet on performance over a shorter time period, so be it, but this should not distract company managers from their long-term goals.

Warren Buffett, the legendary American investor, describes the process of share trading as 'gin rummy capitalism'. Money managers 'discard their worst card at each turn'.

Consider an analogy. The marathon is a 26-mile race. During a marathon, people may take bets on who will run the next mile the fastest. The person who runs the next mile fastest may be well positioned to win the race. But if the runners become so obsessed by the betting on performance in the short term that they exhaust themselves, they are unlikely to succeed.

It is important that company managers understand that much of the questioning they receive from brokers and fund managers will be to help them make a decision about the short-term direction of the company's shares and hence whether or not to buy or sell shares. This is entirely legitimate. But it should not determine the basis on which a company is run. Nor is it an alternative to proper stewardship by shareholders as owners. ■

The best companies ensure they have a proper dialogue with their investors directly, not just through intermediaries

'Some participants in the market seek to bet on performance over a short time period. This should not distract company managers from their long-term goals.'

The Hermes Principles

Hermes' overriding requirement is that companies be run in the long term interest of shareholders. Companies adhering to this principle will not only benefit their shareholders, but also we would argue, the wider economy in which the company and its shareholders participate. We believe a company run in the long term interest of shareholders will need to manage effectively relationships with its employees, suppliers and customers, to behave ethically and have regard for the environment and society as a whole.

Communication

Principle 1 'Companies should seek an honest, open and ongoing dialogue with shareholders. They should clearly communicate the plans they are pursuing and the likely financial and wider consequences of those plans. Ideally goals, plans and progress should be discussed in the annual report and accounts.'

Financial

Principle 2 'Companies should have appropriate measures and systems in place to ensure that they know which activities and competencies contribute most to maximising shareholder value.'

Principle 3 'Companies should ensure all investment plans have been honestly and critically tested in terms of their ability to deliver long-term shareholder value.'

Principle 4 'Companies should allocate capital for investment by seeking fully and creatively to exploit opportunities for growth within their core businesses rather than seeking unrelated diversification. This is particularly true when considering acquisitive growth.'

Principle 5 'Companies should have performance evaluation and incentive systems designed cost-effectively to incentivise managers to deliver long-term shareholder value.'

Principle 6 'Companies should have an efficient capital structure which will minimise the long-term cost of capital.'

Strategic

Principle 7 'Companies should have and continue to develop coherent strategies for each business unit. These should ideally be expressed in terms of market prospects and of the competitive advantage the business has in exploiting these prospects. The company should understand the factors which drive market growth, and the particular strengths which underpin its competitive position.'

Principle 8 'Companies should be able to explain why they are the "best parent" of the businesses they run. Where they are not best parent they should be developing plans to resolve the issue.'

Social, ethical and environmental

Principle 9 'Companies should manage effectively relationships with their employees, suppliers and customers and with others who have a legitimate interest in the company's activities. Companies should behave ethically and have regard for the environment and society as a whole.'

Principle 10 'Companies should support voluntary and statutory measures which minimise the externalisation of costs to the detriment of society at large.' ■

The Hermes Principles

Communication

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A company cannot control its share price, which will be affected by many external factors. However, it can seek to be clear about its goals, and the financial, strategic and ethical disciplines by which it is managed. This will create the best chance of a company being evaluated properly, and gaining the full benefit of access to a lower cost of capital through public capital markets, and of delivering value to its owners. This is a continuing process of providing information and correcting misinformation to ensure the fullest possible understanding of the company by the market. If a company does not communicate properly, it may not get proper credit from its shareholders, even if it is succeeding.

It is important that companies are honest about their prospects, and do not seek to excuse current failure by promising success in the future. For those companies with a long investment time frame, such as those involved in drug development or aerospace, there may be considerable delay between an investment and its subsequent return. However, there may be cases where companies simply promise better return in the future without any credible operational or strategic plan to achieve that improvement. It is therefore important that companies are able to articulate a credible plan as to how and when performance and shareholder value will be

delivered. Many companies do this very well, but a lot of annual reports go into great depth describing the range of a company's activities and aspirations for growth, while failing to explain how or whether shareholder value is being created by these activities.

There is one important rider to this discussion. The price of a company's share reflects the market's view of the company's prospects, and therefore its cost of capital. If a company's share price is low, it probably reflects fundamental doubts about its prospects. Where this is the case, and management are confident that the business is worth more, it is quite appropriate that they should respond by reappraising the capital structure and, if appropriate, buying back their own shares. A company which is maximising shareholder value should always consider a repurchase of shares where this provides superior returns to investing in the business.■

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The Hermes Principles

Financial

Measuring returns

Principle 2 'Companies should have appropriate measures and systems in place to ensure that they know which activities and competencies contribute most to maximising shareholder value.'

Many who work outside the financial system might assume that it is easy for managers to determine whether they are delivering, and for shareholders to determine whether they are getting the best financial returns. In reality things are much more complex. It is therefore important that shareholders are clear about what measures of return companies should use.

The primary goal of a company should be to maximise shareholder value. In financial terms this is best measured by the present value of the cash flows from investment, discounted at an appropriate cost of capital. The best companies are demonstrably aware of the importance of the Weighted Average Cost of Capital (WACC) to all decision making (*figure 1, right*). For most companies, the post-tax weighted average cost of capital (WACC) might be around 7-8% per annum over the long term (*figure 2, opposite*). WACC is an important number. If a company sets it too high, it will discount too heavily the value it creates, particularly over the long term. If it sets it too low, it will invest in a way which destroys value.

Financial reporting disciplines often do not accurately measure or report the cash returns from any investment and hence whether WACC is being achieved. Modern financial accounting is based on measuring the assets of a company (as expressed in the balance sheet), and transactional movements between today's balance sheet, and the one drawn up the previous year (the profit and loss account). It is a hugely important discipline, but one which

Figure 1 WACC – principles

A company will usually be funded by a mixture of equity and debt. WACC – the weighted cost of capital – is the cost of funding taking into account the cost of debt and equity capital.

WACC can be a difficult number to calculate precisely. It is important that investors know that companies understand their cost of capital, but very few companies state clearly in their annual report and accounts their WACC assumptions. Given that WACC underpins the financial goals of a company seen from an investor perspective this is somewhat surprising. One of the few companies that does make a clear statement on its WACC is Geest plc. It is also a good example of frank reporting to shareholders.

'Geest seeks to enhance shareholder value. The average post-tax return on invested capital including goodwill in 2000 was 16% (1999: 17%) versus a weighted cost of capital (WACC) of less than 10%. Geest has had an inefficient balance sheet entirely funded by shareholders, and as a result we have operated with a sub-optimal WACC. As borrowings increase to fund our growth, our WACC will decrease.'
Geest plc annual report 2001

cannot measure the true value of the company.

Basic financial accounting measures are widely used as targets for managers and companies, primarily because the ubiquity of accruals-based, historic cost, financial accounting systems makes them easy to use. If, from time to time, companies wish to focus on such measures, this may be quite appropriate for

Principle 2 'Companies should have appropriate measures and systems in place to ensure that they know which activities and competencies contribute most to maximising shareholder value.'

The Hermes Principles – Financial *continued*

managerial and motivational reasons. Companies should bear in mind that the ultimate goal is long-term shareholder value, and that this is best measured in terms of cash flow returns. We welcome initiatives by companies and their advisers to establish systems based on this measure.

Most companies have planning systems which include a full discounted cash flow model of the options available to them and make objective decisions on this basis. Indeed it is rare for boards of directors to approve any investment which does not demonstrate a positive present value. The question therefore arises; 'if companies plan to deliver shareholder value, why do some fail to do so?'

There are many reasons why the value gap exists. For example, although impact on shareholder value is usually measured before any investment is made, it is less often measured afterwards in a fully objective way. Boards should be encouraged to review investment assumptions and projections after the event to track against reality, rather than just comparing the outcome through budgetary processes. If they don't, managers and investors will have little guide as to which of their decisions have been successful.

Secondly, plans, though based correctly on present value, can fail to incorporate the full consequential costs associated with a project on the whole business.

Thirdly, internal company goals can detract from the creation of shareholder value. For example, companies may encourage the maximisation of returns on capital, rather than the maximisation of

Figure 2 WACC – amount

As this document is written in late 2002, an average FTSE 100 company cost of debt might be around 6% (4% post-tax). A large FTSE company may have a cost of equity of between 7% and 9%. Therefore WACC for an average large FTSE company may be of the order of 7%-8%, and higher where risk perceived by investors increases the cost of both equity and debt capital.

As pension fund investors, our required return on equities is projected at 8%. The FSA assumed investment returns for assessing maturity targets of life policies are 6%-8%. The purpose of highlighting these numbers is not to set expectations for returns on investment, but to set them into context in a realistic way. Reasonable expectations are more likely to result in rational plans that will deliver reasonable outcomes.

Good companies make realistic assumptions. However some are tempted to make unrealistic assumptions about profitability and then discount at a high rate to counter the risk of their optimism. This has implications for the types of projects that will be invested in. With higher discount rates time distant returns count less in relative terms. An overly high discount rate discriminates against longer term projects and builds in unhelpful short-termism.

absolute cash outperformance; or seek to grow scale without delivering value to shareholders.

The Hermes Principles – Financial *continued*

Returns and growth

Principle 3 ‘Companies should ensure that all investment plans have been honestly and critically tested in terms of their ability to deliver long-term shareholder value.’

The purpose of the capital markets, through which most institutions make their investments, is to allocate resources to those companies and projects where there is a high return and away from those which have lower returns. When capital markets work effectively, they will, through this process, encourage high productivity of capital and a high level of economic growth. High capital productivity and high growth will generate long-term shareholder value and strength in the overall economy (*figure 3, right*).

As a shareholder Hermes wishes to promote investment and growth that is sustainable.

We would not want companies to pursue growth for growth's sake. If they do they may prevent investment by other companies which may have a better chance of creating sustainable long-term value. Creating that value usually demands that a company has fully thought through its strategy, a subject which is discussed later.

Figure 3 Growth in the economy and growth prospects of individual companies

The UK Treasury trend growth projections are 2%-3%. Clearly some companies will be capable of achieving growth substantially higher than this. However, as a diversified investor, it has long been apparent that the sheer numbers of companies aspiring to growth substantially in excess of this does not stand up in overall economic terms. We would encourage every company to exploit profitable opportunities to growth. However plans should be based on the reality of likely future customer requirements and on competitive pressures, which mean that real price reductions and service improvements may be needed simply to stand still.

Similarly, trend economic growth is just that, an average. Investment plans should make reasonable assessments of changes in economic circumstances in the normal course of an economic cycle.

Principle 3 ‘Companies should ensure all investment plans have been honestly and critically tested in terms of their ability to deliver long-term shareholder value.’

The Hermes Principles – Financial *continued*

Growth and risk

Principle 4 'Companies should allocate capital for investment by seeking fully and creatively to exploit opportunities for growth within their core businesses rather than seeking unrelated diversification. This is particularly true when considering acquisitive growth.'

Where companies do have the opportunity to grow profitably, they should do so with full momentum, communicate their plans clearly, and expect shareholders to support them. One aspect of sophisticated capital markets is that they allow shareholders to diversify their risk very broadly. At Hermes, we invest our clients' funds in the shares of over 3,000 companies worldwide, plus corporate and government bonds, cash and property.

As shareholders we expect listed companies to exploit their competitive advantages and to grow, provided this generates a capital surplus. This may involve taking considerable risks, and appropriate risk assessment should be done. However, even then we fully recognise that some plans may fail. That is why our investments are spread so widely. As a result we can support companies which take well judged risks in order to grow.

Companies often seem unwilling to take advantage of this, and instead seek to balance risk within their portfolio of businesses. At one time strategic consultants would wrongly recommend that all companies should have a balance of businesses, some of which were generating cash, others of which were spending it. They falsely suggested that if a company had businesses which absorbed cash, it should buy 'cash cow' businesses to fund them. Those with 'cash cow' businesses should acquire businesses which needed investment capital.

Figure 4 Acquisitions

For a company making an acquisition of another, shareholder value will only be created if the acquiring company is able to add value to the acquiree which is greater than any premium they have to pay. Acquisitions can be a way of building businesses that would take years to build from scratch. Acquisitions can be beneficial where companies concentrate on buying activities with which they are familiar and which fall within their own competence and capability. They can, for example, extend the core business' product range or geographical reach. However evidence from firms such as KPMG and PA Consulting has shown that as many as 80% of acquisitions fail to deliver shareholder value. Against this evidence we would urge management to be particularly careful before embarking upon acquisitive growth. There are many pitfalls, not least the acquisition process itself. Companies should stay within the envelope of their proven skills and competences and should not seek acquisitions of businesses outside that boundary. Cultural compatibility between acquirer and acquiree is also essential. Executive incentive schemes should be designed so that acquisition for its own sake, as opposed to enhancing value, is discouraged.

Essentially the advice would be that a company should try to create its own internal capital market. Such approaches make little sense to diversified investors (see figure 4, above).

Conglomeration is not an adequate financial strategy on its own. We recognise we are putting considerable demands on managers. They may feel that they take less risk by backing several business ideas, rather

Principle 4 'Companies should allocate capital for investment by seeking fully and creatively to exploit opportunities for growth within their core businesses rather than seeking unrelated diversification. This is particularly true when considering acquisitive growth.'

The Hermes Principles – Financial *continued*

than putting all their resources and focus into the management of a few of their best opportunities. In that way they may feel they can spread the financial risk. More often, however, such approaches fail. Successful companies are usually the leaders in their field. By minimising financial risk, businesses often increase the likelihood that they will fail to gain a leadership position, and hence they increase their strategic risk. This is not in the long-term interests of shareholders, who have other ways of diversifying financial risk.

We recognise this is a tough discipline to place on managers and may require a change in attitude of investors as well as boards.

Incentivising long-term performance

Principle 5 'Companies should have performance evaluation and incentive systems designed cost-effectively to incentivise managers to deliver long-term shareholder value.'

Over the last few years there has been much debate on the subject of executive remuneration. Headlines have tended to focus on the specific amount of remuneration rather than the principles behind it. For long-term shareholders, the primary issue is simply to ensure that remuneration is adequate to hire and retain appropriate staff, and to incentivise directors and managers to deliver long-term shareholder value. Many remuneration and incentive packages fail to meet these criteria. The fact that they don't is apparent from the continued use of measures which don't reflect long-term value. Many top management incentive schemes are highly geared through options; some pay out for performance which is indifferent when measured on a relative scale, hence they can reward failure as well as success.

As shareholders we are concerned about the generation of value in the long term. Companies should only expand where they can achieve an adequate return. However it does mean that, in taking decisions, directors and managers should be concerned about effects on the long-term value, not just on apparent performance in the short run. If shareholders have been fully informed about long-term company prospects, efficient capital markets will ensure that companies which do take a long-term view will be appropriately rewarded.

Boards need to be sure they are not detracting from

Principle 5 'Companies should have performance evaluation and incentive systems designed cost-effectively to incentivise managers to deliver long-term shareholder value.'

The Hermes Principles – Financial *continued*

long-term performance by the signals they may receive from an investment community concerned with the trading of shares. This was discussed earlier. It is important that corporate managers are not misled by questions which are directed at helping fund managers trade shares, into believing that the objective of a company is to deliver short-term results, whatever the cost. This is not just a problem caused by the behaviour of brokers, or boards overly sensitive to their views, but also the relative passivity and silence of investors in undertaking their stewardship duties.

Lowering the cost of capital

Principle 6 'Companies should have an efficient capital structure which will minimise the long-term cost of capital.'

It is the role of capital markets to make funds available in those areas where return will be highest. It is the role of companies to secure funds on behalf of their shareholders, where costs will be lowest. This means that companies should seek an appropriate balance of debt and equity. If they do so, they will lower their overall cost of capital, thus generating shareholder value.

The appropriate debt/equity ratio is a question for the board, and will be dependent on the particular circumstances of the company concerned. However, we would note that there are companies which have, for considerable periods of time, had substantial cash balances or undergeared balance sheets. This may be inappropriate in an organisation which is seeking to maximise shareholder value.

Equally there are companies which have found themselves 'overgeared', but believe that their relationship with their shareholders is such that they feel unable to come to the equity market for the necessary funds. Sometimes their shareholders' attitude reflects a healthy scepticism about the company and its prospects. However, excessively negative attitudes can also lead to a significant loss of long-term value for shareholders, as companies whose underlying businesses may be strong are forced to take inappropriate measures to protect short-term cash flow. It is therefore essential that there is honest and open dialogue between directors

Principle 6 'Companies should have an efficient capital structure which will minimise the long-term cost of capital.'

The Hermes Principles – Financial *continued*

and shareholders, so that a company can have access to the necessary funds to maintain an effective capital structure.

Investment institutions should support companies seeking to achieve such a goal. ■

The Hermes Principles

Strategic

Strategic expectations

Business unit strategy

Principle 7 'Companies should have and continue to develop coherent strategies for each business unit. These should ideally be expressed in terms of market prospects and of the competitive advantage the business has in exploiting these prospects. The company should understand the factors which drive market growth, and the particular strengths which underpin its competitive position.'

Long-term shareholder value requires the generation of return well into the future. Today's financial accounting returns are often an inadequate predictor of future prospects for shareholder value. This is particularly true for businesses which are highly cyclical or where new investment takes many years to pay back. For this reason, if shareholders are to assess the degree to which a company will generate long-term value, they will need to understand the strategy of its businesses. It is business strategies, quite as much as balance sheet assets, that shareholders invest in.

As with measuring financial returns, it is important that, as shareholders, we define what we consider to be an adequate strategy. We believe an appropriate requirement is that boards should be able not only to discuss the goal of strategy, but also the method by which that goal is to be achieved.

Critical to describing the method is a clear understanding of (i) the demands and the dynamics of the market, and (ii) the business's competitive advantage in terms of, for example, consumer value, cost or access, which allow it to maintain a superior return to other competitors within the market. A 'base

case' assumption must be that if a business has no competitive advantage, it is difficult to see why, over a number of years, it will be able to sustain a superior return, and hence generate long-term shareholder value.

In assessing competitive advantage, a company should be able to explain what particular strengths or resources it has access to, which allow it to maintain the advantage. A company may have a cost advantage which derives from scale, factor costs, brands, technology or a combination of many of these and other features. (These are often referred to as 'core competencies'). The greater the competitive advantage which a company enjoys, the higher should be its profitability relative to other industry participants.

In asking that companies express themselves in this way, we are not seeking to limit the methods by which strategies are created. We are well aware that in good businesses, strategy development is a creative and intuitive activity, subject to organisational, cultural and personal influences, as well as to analytical inputs. We would never wish to stifle this creative process.

However, if shareholders are to be able to understand, and from time to time to challenge, the way in which the companies they own are managed, then there is the need for some minimum expression of the strategy and the competitive advantage which underpins it.

It is therefore an essential requirement that management is able to describe a coherent strategy for each of the businesses they are in. ■

Principle 7 'Companies should have and continue to develop coherent strategies for each business unit. These should ideally be expressed in terms of market prospects and of the competitive advantage the business has in exploiting these prospects. The company should understand the factors which drive market growth, and the particular strengths which underpin its competitive position.'

The Hermes Principles – Strategic continued**Corporate strategy**

Principle 8 ‘Companies should be able to explain why they are the “best parent” of the businesses they run. Where they are not best parent they should be developing plans to resolve the issue.’

What is true at business unit level is equally true at corporate level. Many larger quoted companies participate in a number of different businesses, whether these are defined by market, product or activity. In each case it is essential, if the corporate goal is to generate long-term shareholder value, that the board can explain why it is the ‘best parent’ of any subsidiary company it owns. If a business would generate greater value if it were independent, or managed by another corporate body, then the board should consider plans to divest it. ■

Principle 8 ‘Companies should be able to explain why they are the “best parent” of the businesses they run. Where they are not best parent they should be developing plans to resolve the issue.’



The Hermes Principles

Social, ethical and environmental

Behaving ethically

Principle 9 'Companies should manage effectively relationships with their employees, suppliers and customers and with others who have a legitimate interest in the company's activities. Companies should behave ethically and have regard for the environment and society as a whole.'

Well managed companies cannot ignore the impact of their activities on the wider society. Company activity should be subservient to the law. Basic economic efficiency would argue it is appropriate that companies are open about the impact of their activities. Doing well economically and behaving responsibly are not mutually exclusive.

This does not mean that businesses have limitless social obligations. It is the responsibility of businesses to generate a capital surplus. But it is not appropriate to generate such a surplus without regard to wider obligations.

Of course, to require companies to behave ethically raises many questions, both theoretical and practical. We live in a society where it is appropriate for legislators to pass laws which govern company activities. These do not necessarily set a minimum requirement.

It is not our role to act as moral philosophers, still less do we wish to micromanage companies' responses to ethical issues, any more than we would wish to micromanage their commercial operations. However, we believe that ethical behaviour by companies is likely to involve some notion of fairness and reciprocity; that managers seek to understand the

position of those whom their action affects, and that they deal fairly with them.

Many 'special interests' may challenge corporate activity from a sectional point of view. We would want a company to engage in a process of understanding the appropriate pressure which society is legitimately putting on it, and its industry, and respond accordingly. Once a company has understood the argument it may, of course, be appropriate for it to resist such pressures.

Principle 9 'Companies should manage effectively relationships with their employees, suppliers and customers and with others who have a legitimate interest in the company's activities. Companies should behave ethically and have regard for the environment and society as a whole.'

The Hermes Principles – Social, ethical and environmental *continued***Externalisation of costs**

Principle 10 'Companies should support voluntary and statutory measures which minimise the externalisation of costs to the detriment of society at large.'

Business, of course, has to work in a competitive environment. This can create the conditions where there is a high incentive for businesses to 'externalise' costs – ie to make a profit for the company while high costs are incurred by society at large. Since Hermes opposes such activity we ask companies to welcome those frameworks, voluntary where possible, statutory where necessary, which encourage businesses not to externalise costs. This is not to encourage regulation per se. Of course it is important that where regulation exists it recognises the need to allow the greatest possible flexibility which will encourage positive entrepreneurship. However, most investors are widely diversified; it makes little sense for them to support activity by one company which is damaging to overall economic activity. The ultimate beneficiaries of most investment activity include the greater part of the adult population who depend on private pensions and life insurance. It makes little sense for pension funds to support commercial activity which creates an equal or greater cost to society by robbing Peter to pay Paul. Where companies are aware that such conditions exist, it is appropriate for them to support measures to align shareholder interests with those of society at large. ■

Principle 10 'Companies should support voluntary and statutory measures which minimise the externalisation of costs to the detriment of society at large.'

Conclusion

In this document Hermes has explained what we expect from the companies we invest in. This has implications for financial returns, for strategy and for the wider responsibilities of businesses. We trust that, in our joint enterprise with companies, these principles help set a framework for what companies should expect from responsible investors. We believe that companies with concerned and involved shareholders behaving as owners are more likely to achieve superior long-term returns than those without. We hope that this creates both a constructive platform for communication and dialogue, and a basis on which it is appropriate for shareholders to discuss and question management behaviour.

We believe most businesses in this country do seek to achieve these goals, and do so through a system of corporate governance which meets our governance standards. Management of companies which are run in the long-term interests of shareholders can be confident of Hermes' support, including the expectation that we will support them in a hostile takeover situation and in raising capital.

In drawing up these expectations for companies, we are not seeking to limit management scope or creativity. Still less are we seeking to micromanage companies. The disciplines we have outlined are the natural disciplines we would expect of companies which seek to maximise long-term value for their shareholders.

At all times Hermes stands ready to discuss these expectations with companies. If there are circumstances where they are too rigid we will of course be flexible in responding to particular circumstances. But, barring those specific occasions, we do expect companies to seek to exercise the disciplines we have outlined. For most those disciplines will already be in place. Others will seek to introduce them. Those companies which do not meet our expectations should anticipate that, as engaged owners on behalf of our clients, we will wish to pursue why they have failed to do so.

A corporation is a joint enterprise between its providers of capital and those boards who manage the business. It cannot be right that investors in companies have neglected to behave like owners and instead appear more like spectators observing events without any sense of being able to help determine outcomes.

We look forward to an active and constructive dialogue with the companies in which we invest. ■



The Hermes Principles

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