Vanguard 2018 Investment Stewardship

Semiannual Engagement Update

Vanguard®

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Vanguard funds own shares in more than 13,000 public companies around the world. Our Investment Stewardship team advocates, engages, and votes on behalf of the Vanguard funds to ensure that the actions and values of public companies are aligned to create long-term value for fund shareholders. Engagement is a central part of our program, and these discussions give both sides an opportunity to understand one another's goals, principles, practices, and concerns. In this midyear engagement update, we share examples of the dialogues we've had with company boards and leaders on behalf of the Vanguard funds.

The substance of our discussions with companies is framed by Vanguard's four pillars of investment stewardship:

Board

Our primary interest is to ensure that the individuals who represent the interests of all shareholders are independent, committed, capable, and appropriately experienced.

Compensation

We believe that compensation policies that incentivize long-term outperformance versus peers can drive sustainable, long-term value for a company's investors.

Risk & Strategy

Boards are responsible for effective oversight of material risks most relevant to each company and governance of the company's long-term strategy.

Structure

We believe in the importance of governance structures that empower shareholders and ensure accountability of the board and management.

Board

Good governance begins with a great board of directors. Our primary interest is to ensure that the individuals who represent the interests of all shareholders are independent (both in mindset and freedom from conflicts), capable (across the range of relevant skills for the company and industry), and appropriately experienced (so as to bring valuable perspective to their roles). We also believe that diversity of thought, background, and experience, as well as of personal characteristics (such as gender, race, and age), meaningfully contributes to the board's ability to serve as effective, engaged stewards of shareholders' interests. If a company has a well-composed, high-functioning board, good results are more likely to follow.

Easing our concerns through engagement

When the board of a U.S. materials company invited its major shareholders to engage, we gladly accepted. We had concerns about the board's independence and diversity, and we saw the outreach as a sign that it would be receptive to our perspective. Our board-centric view is the foundation of our approach to investment stewardship and guides many of our conversations. This board was heavily weighted toward nonindependent directors, and we feared that the independent and newer board members could be overpowered by more tenured voices. After a productive engagement, however, we gained an appreciation for the chair's thoughtful approach to board composition, reinforcing our belief in the importance of a dialogue between a company and its shareholders.

The thoughtful evolution of a board

We'd like to provide an update on an engagement story from our 2017 annual report. Since 2016, we have been engaging with a U.S. consumer company and expressing concern over a board that lacked diversity of age, gender, and tenure. We've seen meaningful progress over the past 18 months and significant progress in the past six. In a particularly noteworthy change, the board set a mandatory retirement age that took effect in December 2017, resulting in three open board seats for new directors to bring fresh perspectives. In gender diversity, the board has gone from a laggard to a leader and is actively seeking to add more female directors.

An admirable approach to risk oversight in the energy sector

We went into an engagement with a Dutch energy company wanting to learn more about the board's approach to risk oversight and disclosure. We appreciate the opportunity to engage with companies that take a thoughtful approach to governance and see how those practices translate to value for shareholders. We emphasize the role played by the board of directors, given that the board serves as the shareholders' voice at the company. We were pleased to hear how the company plans extensively for different scenarios and educates the board on how to handle each of them. We were also impressed with the board's approach to strategic evolution and its effort to incorporate a truly diverse range of skill sets, experience, and perspectives. We left the engagement feeling assured by the thought that the board had put into scenario planning and at ease that our clients' investments were in good hands.

Oversight of risk and strategy

Boards are responsible for the governance of a company's strategy and the oversight of risk. Risk and strategy can be viewed as two sides of the same coin: Every strategy involves risk, and every risk can present strategic opportunity.

Through our company engagements—especially in recent years—we've been pleased to see that boards have become increasingly focused on the oversight of strategy. As a long-term investor, Vanguard wants to know how companies think beyond the next quarter and next year. We look to the board to articulate why a company exists and how it will be relevant over decades. Companies get tested along the way, almost constantly. A board that truly understands a company's long-term strategy serves as an assurance to investors that the company doesn't veer off course.

We believe that boards should take a thorough, integrated, and thoughtful approach to the oversight of identifying, understanding, quantifying, and—where appropriate—disclosing risks that have the potential to affect shareholder value over the long term. Importantly, boards should communicate their approach to risk oversight to shareholders through their normal course of business.

A societal risk, a shareholder risk

In the midst of a national health crisis, we reached out to a health care company to continue a meaningful dialogue about the risks facing the company. We wanted to ensure that its board was appropriately overseeing the risks associated with the crisis. This company had recently received two shareholder proposals calling for greater board independence. Given the magnitude of the crisis, we repeatedly expressed our concerns while seeking to better understand how the board actively mitigates risks and holds both itself and management accountable for failing to do so. The engagement provided a forum for us, as large shareholders, to express our concerns in a more articulate way than our vote ever could.

Protecting shareholder assets

Our team contacted an Australian energy company to discuss a shareholder proposal we were considering supporting. Through our engagement, we learned that the proposal would impede various initiatives that the company had already set in place to address the underlying disclosure improvements to which the proposal related. We also gained further insight into certain nuanced aspects of the Australian governance ecosystem that gave us the context to help solidify our decision to vote against the proposal. As a result, we were able to address our concerns through a productive conversation rather than vote for a potentially harmful shareholder proposal.

Talking through regional standards

Our team contacted a South African materials company to request input on a ballot issue at its upcoming annual meeting and to share Vanguard's views on corporate governance. We believed that the company's risk disclosure standards were not on par with governance best practices. Through our conversation with the company, we learned that this particular type of disclosure is not required in South Africa, though the company was more than willing to provide it to its investors upon request. By engaging with the company and performing our due diligence as active shareholders, we avoided a miscommunication over what was simply the result of a regional nuance in market standards.

New lines of communication

We engaged with a Chinese technology company to better understand how its board oversees company strategy and, in turn, to share our own governance principles. We learned that our outreach came as a surprise to the board. Board members said they previously hadn't considered meeting with Vanguard because they typically do not engage with their index investors. They were pleased with Vanguard's interest in the company's long-term value creation and provided meaningful insight into the company's strategy and the board's role in its oversight. As Vanguard continues its global outreach to portfolio companies, we look forward to gaining meaningful insight and sharing our perspectives.

Compensation

We believe that compensation policies linked to long-term performance are fundamental drivers of sustainable, long-term value for a company's investors. The board plays a central role in determining appropriate executive pay that incentivizes performance relative to peers and competitors. Effective disclosure of these practices, their alignment with company performance, and their outcomes are crucial to giving shareholders confidence in the link between incentives and rewards and the creation of value over the long term.

Compensation

Mapping pay to long-term value creation

We agreed to a last-minute engagement with a U.S. technology company to discuss its compensation plan that was coming up for a vote and that we believed did not align with shareholder interests. We saw the engagement as an opportunity to give the company feedback that would add context to our vote. During our engagement with board members, we informed them that we planned to vote against their compensation plan later that day. We shared that the plan was too complex and not fully aligned with the interests of long-term investors.

The next day, we received a follow-up call from the company. We provided more targeted feedback about ways to structure the compensation plan to provide clearer incentives for long-term value creation. Although boards can obtain shareholder feedback thorough the proxy voting process, a yes/no vote provides only limited insight into shareholder views.

A discouraging level of response

We engaged with an American industrial company after expressing our strong concerns over its board composition and executive compensation framework. The board lacked the diversity and independence that we believe are necessary to be engaged stewards of shareholders' assets. In addition, the measures that the company used for its compensation plan did not, in our view, incentivize management to make decisions that are in the best interest of shareholders. Our engagement with the company did not allay our concerns. We were disappointed with its lack of receptiveness to our feedback, and we will continue to engage with the company and to encourage progress on these matters.

An opportunity to build a relationship

An Australian consumer company contacted Vanguard and other large shareholders to discuss its executive compensation plan. Instead of focusing the conversation only on a single ballot item, we decided to use the opportunity to also begin building a relationship. We shared our four pillars of investment stewardship with the company and explained how our program is a natural extension of Vanguard's core values and mission. The engagement revealed that Vanguard and the company have a shared focus on the company's long-term value creation. We came away with a better understanding of the company's governance and a deep appreciation for our shared perspectives.

Lack of shareholder alignment on pay

We have engaged for several years in a row with a health care company regarding its compensation plan. From our perspective, executive pay has not been appropriately aligned with the company's performance. In our most recent engagement, we made several recommendations for how the board could be more transparent and accountable to the shareholders. After another year without observing significant, positive changes to the plan, we elected to vote against the Say on Pay. We found it necessary in this instance to use both our voice and our vote to express our dissatisfaction. We will continue to engage with the company and hold it accountable for failing to address shareholders' ongoing concerns.

Tracking in the right direction

For two consecutive years, we voted against an Australian technology company's remuneration plan. Despite our vote, we continued to engage with the board, provide targeted feedback, and share our philosophy on compensation. Our position as near-permanent shareholders drives us to continue to engage with the board, regardless of our vote history. We believe that the board plays a central role in determining appropriate executive pay that incentivizes performance relative to peers and competitors.

This proxy year, as a result of our ongoing engagement, we were finally able to support the company's compensation plan. The company improved its disclosure, reduced fixed salary and variable pay opportunity, and simplified its remuneration structure. Our team will continue to engage with this company and encourage progress.

A step toward better understanding

In the second half of 2017, we engaged with a Chinese energy company to gain clarity on certain nuances in the Chinese governance space. For example, the CEO in this particular company is not permitted to own stock in it, and this led us to question how the CEO was personally held accountable for the company's long-term performance. We also raised our concern about the composition of the board, which had no female directors. We were encouraged by a follow-up from the company asking how we define and measure good governance. Vanguard will continue to seek thoughtful dialogue and engage with this company and others in the region.

Governance structures

We believe in the importance of governance structures that empower shareholders and ensure the accountability of a company's board and management. We believe that shareholders should be able to hold directors accountable as needed through certain governance and bylaw provisions. Among these preferred provisions are that directors must stand for election by shareholders annually and must secure a majority of the votes in order to join or remain on the board. In instances where the board appears resistant to shareholder input, we also support the right of an appropriate proportion of shareholders to call special meetings and to place director nominees on the company's ballot.

Aligning with norms on proxy access

We engaged with a Canadian financial firm to discuss a shareholder proposal on proxy access that was put forth on its ballot. We believe that long-term investors can benefit from proxy access—the opportunity to place director nominees on a company's proxy ballot. That said, we also believe that proxy access provisions should be appropriately limited to avoid abuse by investors who lack a meaningful long-term interest in the company.

Through our engagement, we learned that the company was in compliance with the Canadian market standard of a 5 percent ownership threshold for proxy access. This gave us the appropriate degree of context, and we ultimately decided it was in the funds' best interest to vote against the proposal. In our conversation with the company, however, we expressed our perspective on the benefits of a lower threshold for proxy access. For example, a 3 percent threshold has been widely adopted by U.S. companies.

We were pleased to learn during a follow-up engagement that the company was working with a peer to create a dialogue with the Canadian minister of finance about adopting a lower industrywide threshold for proxy access.

Standing up for all shareholders

We engaged with a transportation company after shareholder support was low for a compensation plan put forth on the 2017 proxy ballot. We wanted to use the opportunity to provide targeted feedback so the company could begin to better align its practices with the interests of shareholders.

While preparing for the engagement, we noticed that on the same 2017 proxy, a shareholder proposal on the "right to act by written consent" had passed. These two ballot items stood out to us because, although they covered different governance topics, they both represented forms of shareholder disapproval.

Although Vanguard did not support this particular shareholder proposal, we took advantage of our engagement to underscore the importance of a company's being responsive to its shareholders.

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