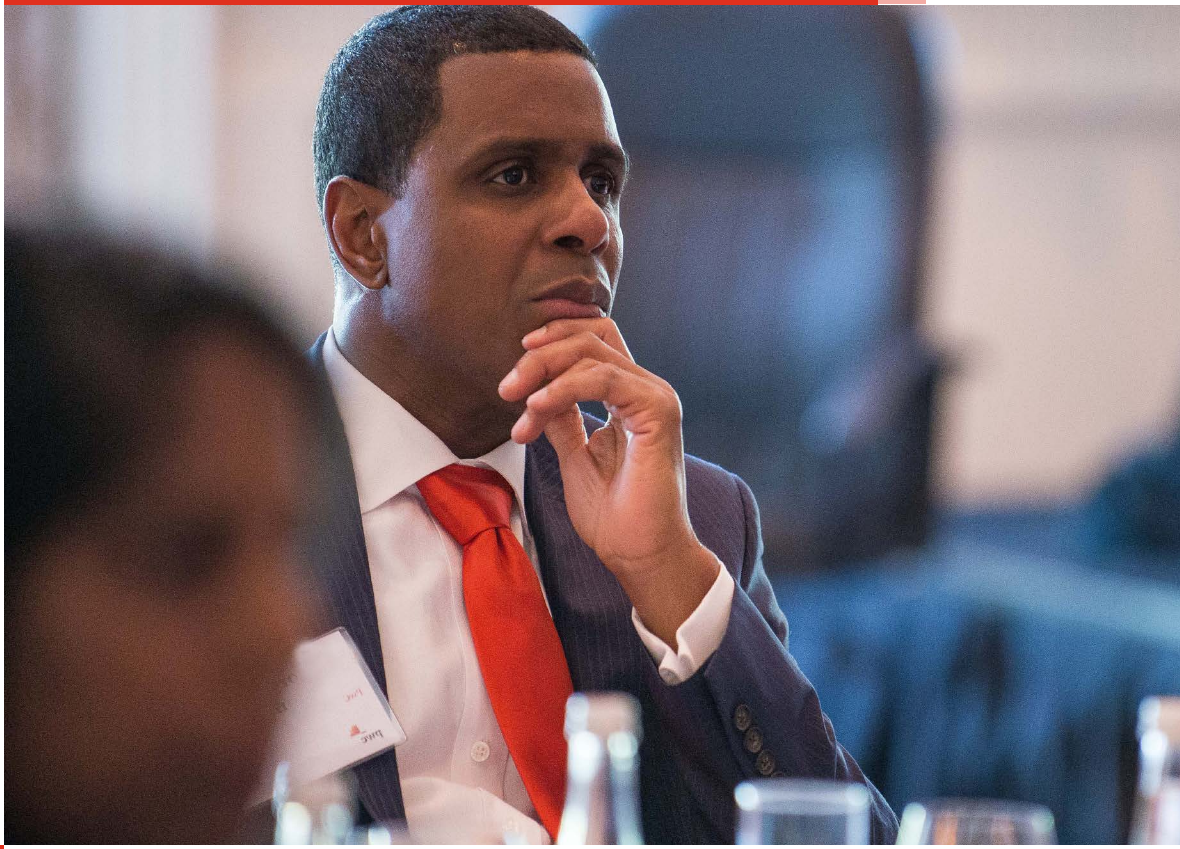
Investor Exchange 2014: Sharpening the impact of the institutional investor

November 2014
Investor Resource Institute



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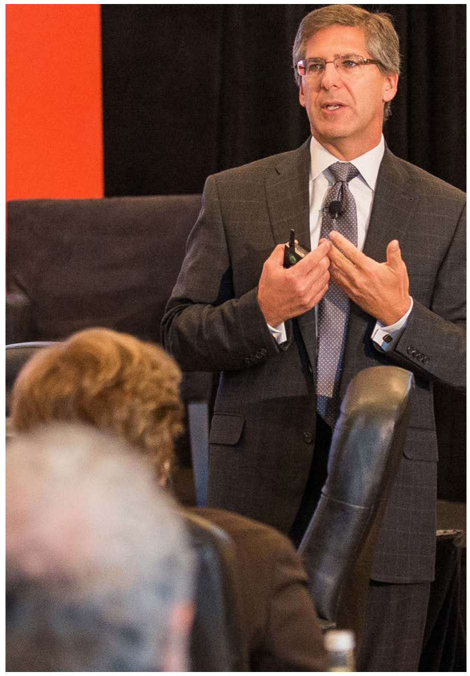
The views represented by conference attendees do not necessarily represent PwC's views

In October, institutional investors, corporate officials, and governance specialists got together in Boston at *PwC's second annual Investor Exchange.* The goal: to exchange ideas, discuss important issues, and find opportunities to collaborate in the future. Investors got a glimpse into what goes on between an audit committee and auditor in real-life situations borrowed from today's headlines, and they heard from an activist investor. They talked about shareholder-corporate engagement and how five macroeconomic megatrends are impacting corporate strategies. Together, the attending investors manage approximately $8 trillion in assets.[1] The following provides highlights from these discussions.

1 Calculated from attendees' online self-reports, with information retrieved on October 21, 2014.

A look back at the past year

What's happened in the last 12 months? CEOs are moderately optimistic about where the global economy will be in the next year, though that sentiment varies by region.[2] Stock markets are generally up, though uncertainty about global economic growth and geopolitical tensions have caused volatility in the fourth quarter. The global recovery is inching along, but concerns about Europe and China are causing some revisions to expectations. And worries about disease and terrorism are growing, adding to the nervous sentiment.



What does this mean for investors? As the title suggests, the conference was about exchanging insights and views between investors and PwC. Investors are eager for information that will help them make decisions, and we're here to try to provide insights—insights based on our particular vantage point that might not be available elsewhere. That's what the Investor Exchange was all about.

"Through this process of sharing perspectives, we'll find opportunities to collaborate and work together to help solve some of today's problems."

—Robert E. Moritz, PwC, US Chairman and Senior Partner

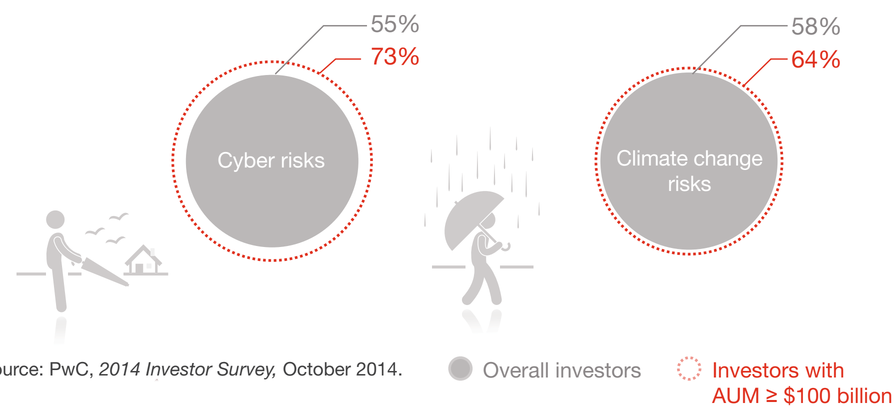
Investors eye risks

Two of investors' biggest concerns are cyber threats and climate change. More than 70% of investors who manage assets over $100 billion said they're not happy with the information companies are providing about their cyber risks, and 64% say the same about climate change risk.[3]

What concerns investors?

Investors aren't happy with the information available to them about some forms of risk

Investors who responded "dissatisfied" with the information companies provide



Source: PwC, *2014 Investor Survey*, October 2014.

2 PwC, *17th Annual CEO Survey*, January 2014.
3 PwC, *2014 Investor Survey*, October 2014.

What about the future?

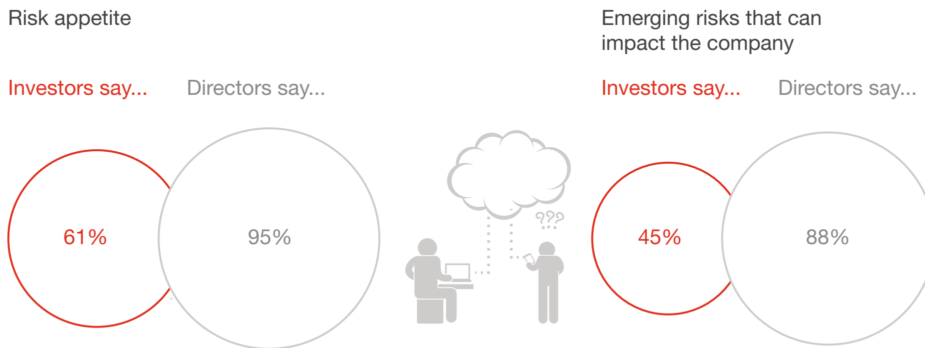
Investors are also very concerned about risks that may emerge in the future. Directors are much more confident in their own understanding of risk issues than investors believe is the case: 95% of directors say they understand their company's risk appetite at least moderately well. That's compared to just 61% of investors who say the same. Almost 90% of directors say they at least moderately understand emerging risks that can impact their company, compared to just 45% of investors who say the same of directors.[4]

Where do investors and directors differ?

Investors and directors don't always share the same opinions about governance issues

How well do directors understand risk issues?

Respondents who said "very well" or "moderately well"



Source: PwC, *2014 Investor Survey,* October 2014; PwC, *2014 Annual Corporate Directors Survey,* October 2014.

Planning for the future: How will today's megatrends affect tomorrow's investment opportunities?

Megatrends are macroeconomic forces that are shaping the world. They're big. They're based on science. And they affect society overall. If companies don't address them, they risk becoming irrelevant.

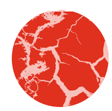
Accelerating urbanization

Stat: *A hundred years ago just two out of ten people lived in cities. Today more than half the world's population lives in cities, and seven out of ten people will be urban dwellers by the middle of this century.*[5]

What does this mean?

Space will be tighter, infrastructure will be more crowded and challenging, and big changes will have to take place in terms of public transportation, parking, healthcare, education, and even the size of your home. The way energy is produced and consumed will change, as will the pricing of healthcare, insurance, and manufacturing delivery systems, among others.

Climate change and resource scarcity



Stat: *With a world population projected to be 8.3 billion by 2030, experts project that the demand for energy will increase by 50%, but there are only fifty years left in proven oil reserves (assuming current levels of energy demand continue). Water withdrawal will increase by 40%, but today only 3% of the world's water supply is fresh, and three-quarters of that is locked in glaciers.*[6]

What does this mean?

Resource scarcity is likely to implicate geopolitical tensions, particularly when resources might not keep up with the demographic shifts that are occurring. Traditional methods of farming, hunting, and fishing could become more difficult or even impossible in some places, due to extreme weather and rising sea levels.

4 PwC, *2014 Annual Corporate Directors Survey,* October 2014; PwC, *2014 Investor Survey,* October 2014.
5 "PwC Megatrends," PwC, accessed November 10, 2014, http://www.pwc.co.uk/issues/megatrends/index.jhtml.
6 *Ibid.*

Demographic shifts

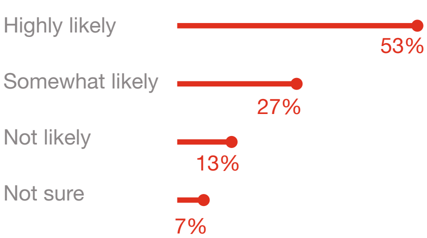
Stat: *Half of the world's population growth over the next forty years is expected to come from Africa. In Japan, the declining birthrate, coupled with depopulation in many rural areas, is causing 400 to 500 schools to close in that country every year.*[7]

What does this mean?

Demographic shifts will require global mobility: Employees who are willing and able to accept work assignments outside their home countries will be more in demand than ever. The dramatic increase in the number of people aged 65 or older will put pressure on pension funds and other investment vehicles traditionally relied upon to generate retirement income.

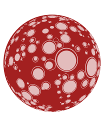
Polling question:

Q: Will an increase (both globally and in the US) in the over-65 population affect your business or investment products?



Source: 2014 Investor Exchange, October 6, 2014.

Shift in global economic power

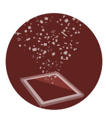


Stat: *By 2030, the global middle class will more than double—to about 4.9 billion from 2 billion today. And by 2030, Asia will host 64% of the global middle class and account for over 40% of global middle class consumption.*[8]

What does this mean?

Explosion in the middle class has opened up consumption, so there are huge opportunities developing. Western economies will continue to be important, but they will become a matter of relative importance across the globe. And companies are going to start searching for talent differently in order to take advantage of population growth in emerging countries. More than 90% of CEOs recognize the need to change, or are changing, their strategies for attracting and retaining talent.[9]

Technological breakthroughs



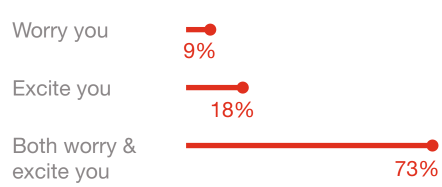
Stat: *On average, each US consumer spends about an hour on his or her smartphone every day. Today, there are about three connected devices for every person across the globe; in just six years, it's projected that there will be seven times more connected devices than there are people.*[10]

What does this mean?

Technology creates amazing leaps forward—new products, new ways to do business, and even entry into new markets. But there are always related risks. Security is a huge concern for companies, investors, and consumers alike. And technology also means disruption: Traditional industries are being shaken up more often and by smaller players today—just think about disruptions to the taxi and video rental industries. Experts predict that about half of all US jobs that exist today are at risk of being computerized over the next twenty years.

Polling question:

Q: Does the scope and impact of future technology innovations:



Source: 2014 Investor Exchange, October 6, 2014.

7 *Ibid.*
8 *Ibid.*
9 PwC, *17th Annual Global CEO Survey,* January 2014.
10 "PwC Megatrends," PwC, accessed November 10, 2014, http://www.pwc.co.uk/issues/megatrends/index.jhtml.

Behind closed doors: Auditor and audit committee interaction

How do auditors work with audit committees on routine matters—and what happens when difficult situations arise? Investors got the chance to be a fly on the wall and witness the interaction between an audit committee and audit team around a series of real-life situations.

Act One:

Investors joined the audit committee meeting with the engagement partner as they discussed the scope of this year's audit. This was a short excerpt illustrating the complexity and depth of the audit planning process.

What usually goes on?

The auditor needs to fulfill a number of professional obligations during the planning meeting. The auditor will discuss the audit strategy, including timing and significant risks. The engagement partner will touch on how the auditor determines which accounts and locations will be included in the audit scope and will discuss the auditor's responsibilities with regard to fraud. The auditor may also introduce relevant hot topics of the day and their impact on the audit approach. Given their responsibilities for oversight of financial reporting and the external auditors, audit committees are actively involved in discussing the audit plan and may request certain additional procedures in specific areas of interest, as needed.

Acts Two and Three:

Our hypothetical company, International Big Co. (IBC), is hit by a whistleblower's public allegation of earnings manipulation just days after the company filed its second-quarter 10-Q. A few months later, IBC voluntarily discloses that certain employees made payments to foreign government officials to help move inventory through customs, a potential Foreign Corrupt Practices Act (FCPA) violation.

What happens now?

In each of these situations, investors watched as investigations—by both the company and the auditor—were planned. The audit committee typically leads the company's investigations of this type, overseeing outside counsel and other experts and ensuring coordination with the auditor's separate and independent review. The auditor will also share its view on the independence of anyone hired by the audit committee to assist with the investigation, as well as issues regarding disclosure.

Polling question:

Q: Which part of the auditor's response to the potential illegal act is most important to you as an investor?

Source: 2014 Investor Exchange, October 6, 2014.

A conversation about shareholder-corporate engagement

The debate about direct dialogue between boards and investors is still hot. Investors today say engagement with directors has been increasing. But 48% aren't happy with the dialogue.[11] And directors are cautious about the practice. Should investors and directors talk to each other directly? Conference attendees say it's not always clear—it depends.

Communication lines are opening

Direct dialogue between investors and directors can be beneficial under certain circumstances, but it often depends on the subject matter. Discussing governance issues makes sense, according to the panel, and investors believe executive compensation, board composition, shareholder proposals, management performance, and risk management are important topics for direct communication.[12] But some investors believe that it may not be the best use of time to discuss other matters with boards. Investors have different objectives and perspectives, so one size does not fit all. And most interactions take place when they need to take place, the panelists agreed.

"Directors should not feel obligated to engage with us for engagement's sake. They should approach us—and we will approach them—when we have something significant to discuss."

—Donna Anderson, VP and Global Corporate Governance Analyst, T. Rowe Price

What should we talk about?

Q. How important is it for corporate directors to engage with you in direct communications about the following topics?

Base: 33

Source: PwC, *2014 Investor Survey,* October 2014.

What's the board's perspective?

While a number of directors say they're communicating more with institutional investors, there's no broad consensus about whether directors should engage directly with shareholders. And 62% of directors say it's not appropriate to talk to shareholders directly about any subject[13]—many believe direct communication should be left to the executive team.

Some directors are more open to the practice and are proactive about it. Typically, boards and management first determine whether it would be valuable to engage directly, and if so, they identify the right directors, appropriate topics, and best approach for initiating that dialogue. Certain board members could be designated to talk about the way risk is measured and brought to the table, for example.

"It may be dangerous not to have a meeting with a large investor if it has asked for one."

—Kenneth A. Bertsch, Partner, Camberview Partners, LLC

11 PwC, *2014 Investor Survey,* October 2014.
12 *Ibid.*
13 PwC, *2014 Annual Corporate Directors Survey,* October 2014.

Inside an activist's mind

Hedge fund activist Nelson Peltz, founding partner and CEO of Trian Partners and one of the earliest activist pioneers, was one of our keynote speakers. In aggregate, activist investors hold more than $100 billion in assets, leading some to believe that shareholder activism is the "new normal."[14] Activist hedge funds have been taking center stage in recent years, and they're likely going to stay in the spotlight, at least into the foreseeable future.

Who are today's activists?

Activists are not all the same—they have different strategies and time horizons. But often they have goals similar to many long-term institutional investors—sustained earnings and growth and enhanced shareholder value. Some (and perhaps most) also have longer perspectives than simply short-term gains in stock prices.

What do activists want?

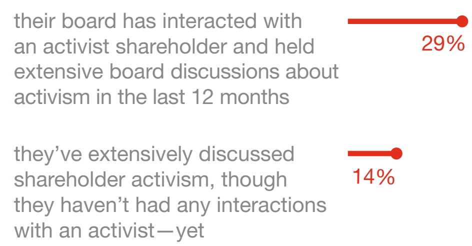
Some activists target poorly managed companies, others want cash returned to shareholders through dividends or share buybacks, and others want companies to spin off underperforming or non-core parts of their businesses. Trian's stated strategy involves investing in public companies with attractive business models that Trian believes trade significantly below intrinsic value due to operating underperformance.[15] Often, activists are also looking for a seat on the board in order to help effect these changes.

And activism is likely to continue. Despite an uptick in recent M&A activity, some attendees believe the next five to seven years will likely continue to produce a target-rich environment for activism.

How do institutional investors view activists?

As one conference attendee noted, "good ideas can come from anyone." Most investors spend significant time considering an activist's views about how a particular company's value can be enhanced—and they expect the company's management and board to be similarly open and thoughtful. Another conference attendee recommended that directors consider an activist's suggestions "as if his or her own personal net worth is tied up in the company," because that is how investors view it.

Percentage of directors who say...

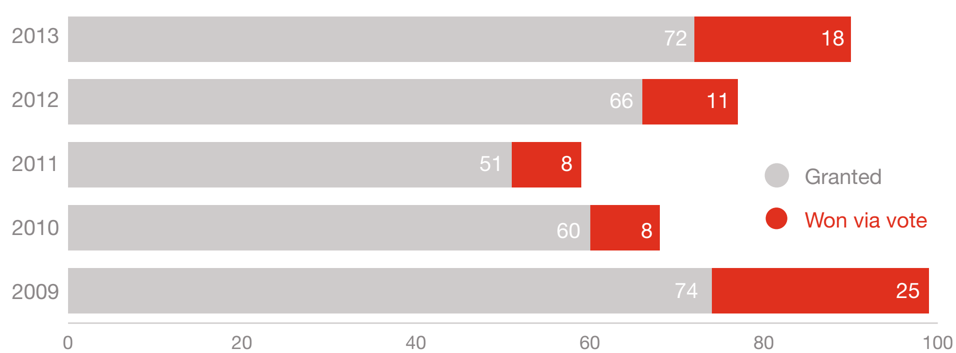


Source: PwC, *2014 Annual Corporate Directors Survey*, October 2014.

Activists increasing success gaining board seats at US companies

Campaigns resulting in board seat(s)

Based on seat won/granted date



Source: FactSet SharkRepellent, New York, March 10, 2014.

14 Bill George and Jay W. Lorsch, "How to Outsmart Activist Investors," *Harvard Business Review,* May 2014, accessed October 17, 2014.
15 "About Us," Trian Partners, accessed October 27, 2014, https://www.trianpartners.com/about-us/.

We appreciate the input of those investors—representing over $8 trillion in assets under management—who participated in our second annual Investor Exchange. As the work of PwC's Investor Resource Institute advances, we will continue to seek this input and share results with the investment community, as well as with corporate officials and regulators. Please watch our progress at:

www.pwc.com/us/InvestorResourceInstitute

To have a deeper conversation about how this subject may affect your business, please contact:

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PwC's Investor Resource Institute seeks to add value to investors' decision making processes by sharing PwC's insights and educational materials regarding markets, industries, and corporate governance, thereby strengthening their understanding of the information available to them.