

SHAREHOLDER ADVOCACY NEWS

WINTER 2018

**"Increasing transparency
makes markets more
efficient & economies
more stable & resilient."**

—Michael Bloomberg,
in the Final Report for the
Financial Stability Board's
Task Force for Climate-related
Financial Disclosures (TCFD)
Recommendations ¹

GOVERNANCE: THE "G" IN ESG

As an asset manager with decades of experience looking at the totality of companies, Miller/Howard has long believed that analysis of environmental, social, and governance (ESG) factors, when combined with robust financial analysis, provides a more comprehensive picture of a company's risks and opportunities. We often talk about the environmental and social angles, yet the governance aspect often goes unexplained. Understanding a company's governance—and demanding transparency—is critical for any investor interested in long-term profitability, responsible use of capital (financial, human, natural), and the company's risk profile.

Many investors have only a fuzzy idea of what governance is. Governance refers to the various policies, practices, management, and structure of an organization that are critical to its operation.

In this piece we highlight some elements of governance we consider important to all companies and their shareholders: board structure, including diversity and independence, and executive compensation. This discussion is not intended to be exhaustive.

DIRECTORS AND EXECUTIVE LEADERSHIP

What is the relationship between shareholders and company leadership?

Leaders ultimately answer to shareholders, which is why shareholder involvement is key. As shareholders, we are the owners of a company, and our fortunes are linked directly to company success, or lack thereof. Shareholders are generally responsible for electing board directors, a significant concern given that directors are vital for setting the strategy for the entire company.² In turn, the directors choose the CEO, who is responsible for running the company with support from an executive leadership team.

In the words of former SEC Commissioner Luis A. Aguilar, shareholders "provide the capital that businesses need to grow, compete, succeed, and create jobs. They are, in a very real way, the fuel that keeps the engine of our economy moving."³

Exercising our rights as shareholders by voting on nominations for the board of directors allows us to participate in the company's trajectory for the future.

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DELOITTE GOVERNANCE FRAMEWORK



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SEPARATION OF CHAIR AND CEO

One issue of concern for shareholders is the independence of the board chair, because board chairs are generally powerful in their ability to set company agendas and steer director focus. When the CEO is also the board chair, known as an executive chair, shareholders are better served by being vigilant as to whose interests are being served.

There's evidence that executive chairs don't act as quickly to deal with their underperforming peers. The 2017 Corporate Directors Survey from PricewaterhouseCoopers found that "directors on boards with nonexecutive chairs are more than twice as likely to say that their assessment resulted in the board providing counsel to a director, or deciding not to renominate a director."⁴ That's good governance at work.

To further encourage the adoption of policies or by-laws that serve to mitigate the risks and distortions that can occur when power is concentrated, some companies appoint a lead independent director who presides over meetings to which executive chairs are not invited.

USE OF A SKILLS MATRIX

One of the best practices for board succession planning is to use a skills matrix, a table that clearly and visibly illustrates the skills and competencies held by individual board members. Ernst & Young notes that the purpose of a skills matrix is "to proactively shape board composition that incorporates strategic direction and opportunities, regulatory and industry developments, challenges, and transformation."⁵ It also gives the board a framework for self-assessment.

For shareholders, some of the most useful company proxy statements include an explicit breakdown of the skill sets represented on the board. A matrix makes it easy to see where the board is strongest, and where it may face gaps when sector- and issue-related questions arise that could affect a company's performance.

To make an effective team, a board must be expansive in its ability to meet, or at least comprehend, the breadth of issues faced by the company. If all directors on the board of a tech firm have financial expertise, for example, but none have passable understanding of cybersecurity, or if all directors of an energy company have industry background but none can describe the difference between climate and weather, leadership becomes myopic. Such leadership may not be able to adequately identify, assess, or lead mitigation efforts related to existing or emerging risks.

TENURE OF INDEPENDENT DIRECTORS

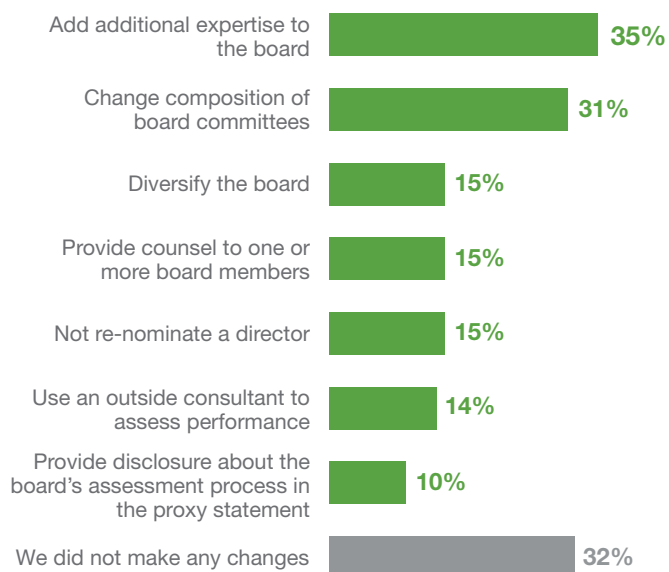
Another area of concern is tenure, particularly of independent directors. Shareholders want to know that directors retain their autonomy, their ability to be critical and open-minded, and that they are not falling into entrenched habits and behavior patterns that could hinder innovation, growth, and long-term profitability.

Earlier this year, Institutional Shareholder Services found that "companies with directors concentrated in one or two tenure categories exhibited the worst performance and the highest risk profile."⁶

We support the practice of many jurisdictions that require companies "to disclose clear rationales when appointing long-tenured directors as independent members of the board."⁷ We look to the company proxy statement to understand how the nominating and governance committee explains its choice of nominees, and sometimes the question is, "Why is old blood better than new?" If the company cannot provide a satisfactory answer, shareholders may choose to vote accordingly.

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BOARD ACTION ON ASSESSMENTS



15%

Only about one in six directors (15%) say that a member of their board was provided with counsel or was not re-nominated as a result of the assessment process

Source: The governance divide: *Boards and investors in a shifting world*, PwC's 2017 Annual Corporate Directors Survey.

EXECUTIVE COMPENSATION

As shareholders, we want to monitor how executives at public companies are rewarded and incentivized. Executive compensation can include: annual salary or base pay; long-term incentives such as stock options; short-term incentives such as annual bonuses; and perks such as use of a company jet. If well-constructed, compensation plans clearly align with the company's long-term goals, leadership effectiveness, and performance metrics.

COMPENSATION AND ETHICS

Interestingly, a Bloomberg January 2018 article suggests that executives' ethical decisions are not necessarily secured by large compensation packages. It lists the 10 biggest CEO compensation packages in 2016, the most recently available data at the time. As of this writing in October 2018, two of those CEOs have been ousted from their roles due to various behavioral missteps and possible illegal activity.⁸

Similarly, Axios pointed out that a "gigantic portion of what CEOs make comes in the form of vested stock, and those incentives drive their decision making. The analysis shows that since the Affordable Care Act was passed, healthcare executives routinely took measures to inflate stock prices."⁹

PAY DISPARITIES AND PROFITS

CEO pay disparities have become an issue of sharp concern for shareholders, especially because those funds could be distributed to shareholders in the form of dividends in return for the investment risks they bear, or to hard workers whose paychecks have perhaps not significantly climbed at all.

A piece by CBS earlier this year reported that in 2017, the median package for "CEO pay of \$11.7 million was 164 times typical worker's salary last year."¹⁰ An article in Bloomberg from January 2018 began, "the gap between pay for US chief executive officers and the people who work for them has widened sixfold in three decades."¹¹

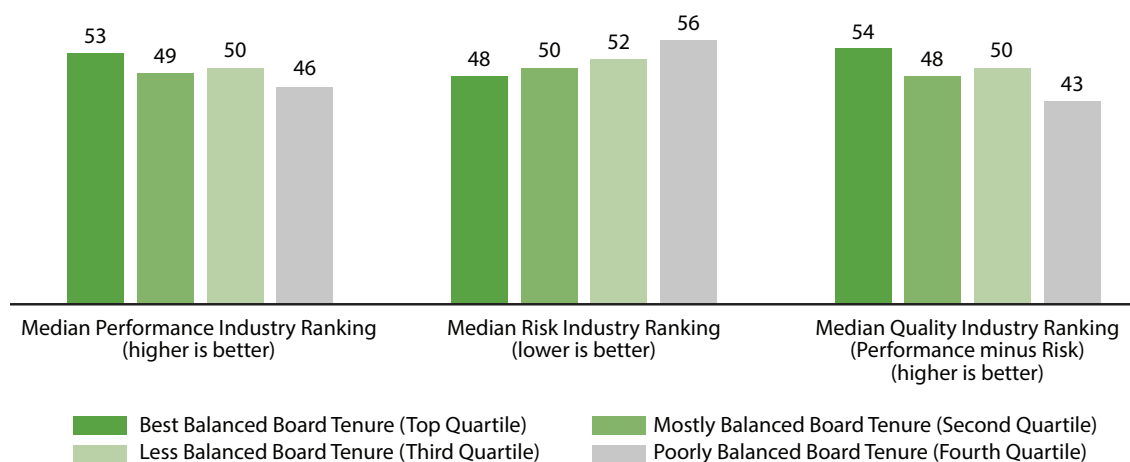
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WHAT IS SAY-ON-PAY?

Say-On-Pay is shorthand for Section 951 of the Dodd-Frank Act,^{12, 13} which allows periodic advisory, or nonbinding, votes by shareholders on a public company's executive compensation. These votes occur during the annual general meeting, where other items may also be presented to shareholders for consideration. The intention is to provide greater transparency into corporate compensation practices, and to ensure heightened accountability to investors and shareholders.

COMPANIES WITH BALANCED BOARD TENURE SHOW BETTER PERFORMANCE & LOWER RISK

Performance, Risk, and Quality ISS EVA PREvit Percentile Rankings by Tenure Balance Category
Russell 3000 Companies with Meetings from January to June 2018



Source: ISS Analytics, the data intelligence arm of Institutional Shareholder Services Inc.

Some claim that this gap is the result of increased economic productivity, but a study by the Economic Policy Institute tells us otherwise: "Higher CEO pay does not reflect correspondingly higher output. CEO compensation has risen by 807 or 937% (depending on how it is measured—using stock options granted or stock options realized, respectively) from 1978 to 2016. At 937%, that rise is more than 70% faster than the rise in the stock market; both measures are substantially greater than the painfully slow 11.2% growth in a typical worker's annual compensation over the same period."¹⁴

COMPENSATION COMMITTEE ROLE

Addressing all of these issues is where the compensation committee comes in. Shareholders want to keep an eye on whether the board-level compensation committee is making decisions about executive compensation that are in the best interest of company success. "Clawback clauses" are one tool some compensation committees deploy to incentivize good behavior. Written into an employment or compensation arrangement, clawback provisions require the return of funds already paid, plus a penalty, under certain conditions. For example, as part of the fallout from a recent banking industry scandal, Wells Fargo "imposed forfeitures, clawbacks, and compensation adjustments on senior leaders totaling more than \$180 million."¹⁵ This allowed shareholders to recover a small portion of the damage caused during these leaders' tenure.

CONCLUSION

Miller/Howard's clients range from foundation to family trust, from institution to individual, but all share a common desire to see an economically secure and profitable future. Our ESG clients want that same future, and many also want to use their investments to enjoy environmental and social returns too—in the form of pushing companies to improve policies, practices, and management of resources. Ultimately, the success of any measure rests with the structure and management of a company.

As stewards of our clients' investment dollars, we take the "G" in ESG seriously. We ask companies for: (1) transparency around governance, such as publicly available policies; (2) clarity around the skills matrix they use during board construction; (3) information on how boards review and refresh their board composition; and (4) disclosure on executive compensation.

Proactively reviewing governance allows us to better assess the companies in which we invest. We look for companies that can be trusted to appropriately and ethically conduct business and use all capital at their disposal—financial, human, and environmental. Governance provides the foundation on which future performance is built.

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ACTIONS SHAREHOLDERS CAN (AND DO!) TAKE

FIRST, COMMUNICATE WITH MANAGEMENT!

Miller/Howard is proud of its relational approach, in which we attempt to start conversations with company management when we see potential issues and then work with the management to close gaps and mitigate risk. This is part of our Active Ownership / Shareholder Advocacy program, which includes active voting of proxies (rather than merely rubber-stamping management recommendations).

SECOND, VOTE PROXIES!

Concerned about executive compensation?

- Vote “nay” on the advisor “Say-on-Pay” ballot measures. While nonbinding, significant shareholder opposition sends a serious signal to the company.

Wondering about strategy alignment and a particular issue?

- File and support shareholder resolutions that ask for a report, prepared at a reasonable cost and omitting proprietary information, on the particular issue. This triggers attention to an issue, which may or may not have previously been on management’s radar, and provides greater transparency and accountability to investors.

Concerned about diversity and board tenure?

- Withhold votes, or vote against, directors who also serve on the nominating and governance committee during a time when the board had insufficient diversity or failed to appoint a new director within the previous five years.
- File (or support) shareholder resolutions that request adoption of a policy that requires search firms to include qualified, diverse candidates in the initial list provided to the nominating/governance committee.

Concerned about takeover bids?

- Look for staggered directorships. There may be a protective effect if not all directors are up for re-election simultaneously.

Read more about Miller/Howard’s approach on our website.

ISSUES TO WATCH

The Task Force on Climate-Related Financial Disclosures (TCFD)¹

Do your investments face climate-related risks and opportunities? For the vast majority of investors, the answer is likely to be yes, either now or in the near future. The Financial Stability Board (FSB)—“an international body that monitors and makes recommendations about the global financial system” —appointed a task force to study and offer guidance regarding disclosures on climate-related risks and opportunities, specifically in financial filings.

In the Final Report on the Recommendations, released in 2017, the task force wrote: “One of the most significant, and perhaps most misunderstood, risks that organizations face today relates to climate change. While it is widely recognized that continued emission of greenhouse gases will cause further warming of the planet and this warming could lead to damaging economic and social consequences, the exact timing and severity of physical effects are difficult to estimate. The large-scale and long-term nature of the problem makes it uniquely challenging, especially in the context of economic decision making. Accordingly, many organizations incorrectly perceive the implications of climate change to be long term and, therefore, not necessarily relevant to decisions made today. The potential impacts of climate change on organizations, however, are not only physical and do not manifest only in the long term.”

With respect to governance (one of the four thematic areas identified in the report), the TCFD recommends that disclosure of the governance around climate-related risks and opportunities be included in financial filings, and that they “(a) Describe the board’s oversight of climate-related risks and opportunities [and]...(b) Describe management’s role in assessing and managing climate-related risks and opportunities.”

Miller/Howard and other investors are increasingly requesting that companies begin to disclose in alignment with TCFD recommendations.





How Can Directors Build Climate Competency Into Their Board?

- Drive the assessment of whether climate change is material to their business, including how it could affect shareholder value in the long term
- Formally include climate change oversight in the board structure by incorporating it within board committee charters
- Recruit climate-competent directors by casting a wide net through the nominating process to identify candidates with expertise in addressing climate change
- Educate the whole board on climate change
- Integrate climate change into strategic planning and risk oversight to ensure that the business impacts of climate change are accounted for at every level of the company
- Tie executive compensation to climate change
- Promote climate change disclosure based on the new Task Force on Climate-related Financial Disclosure (TCFD) guidelines

Source: Ceres Getting Climate Smart: A Primer for Corporate Directors in a Changing Environment (May 2018)

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INVESTMENT TEAM

Lowell G. Miller, Founder, Chief Investment Officer
Gregory L. Powell, PhD, Deputy Chief Investment Officer
John E. Leslie III, CFA, Portfolio Manager
Bryan J. Spratt, CFA, Portfolio Manager
John R. Cusick, CFA, Portfolio Manager
Michael Roomberg, CFA, Portfolio Manager
Adam Fackler, CFA, Senior Research Analyst
Owen D. Harvey, Research Analyst
Mark A. Phillips, CFA, Research Analyst

ESG RESEARCH & ADVOCACY TEAM

Luan Jenifer, Chief Operating Officer
Nicole Lee, Lead ESG Analyst
Patricia Karr Seabrook, Shareholder Advocacy Coordinator
Daniel Lee, ESG Research Associate

Miller/Howard Investments
10 Dixon Avenue, Woodstock, NY 12498
Tel 845 679-9166 | Fax 866 901-9071
esg@mhinvest.com
www.mhinvest.com/esg



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INVESTMENT PRODUCTS: ARE NOT FDIC INSURED • MAY LOSE VALUE • ARE NOT BANK GUARANTEED