LEND ME YOUR EARS, NOT YOUR STOCKS

Scott Nisbet, Partner. Fourth Quarter 2018

BAILLIE GIFFORD

RISK FACTORS

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The undernoted table shows which examples from this paper were held by Baillie Gifford at 31 December 2018.

Company	Baillie Gifford Share Holding in Company
Tesla Inc.	7.64%
ASOS	7.70%
British Land	0.37%
Melrose Industries / GKN	0.45%

Source: Thomson's Reuters.

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The images used in this article are for illustrative purposes only.

Cover Image: Old statue of Julius Caesar.

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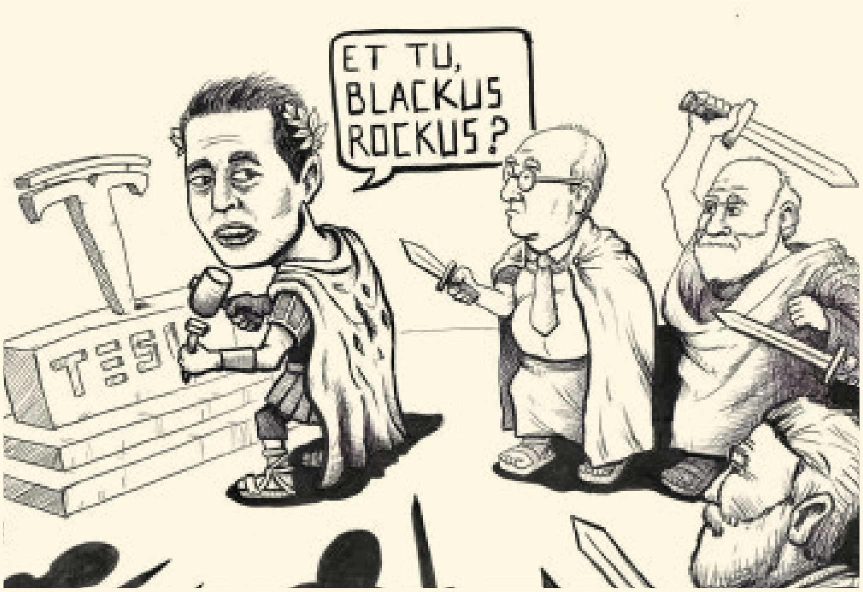
BEWARE THE VOTES OF MARCH

Gaius Julius Caesar rightly feared being stabbed one day. The surprise was that his Ides of March assailants turned out to be his own allies: Brutus, and his 'honourable' men.

There are a few CEOs who must have felt like Caesar in recent years, attacked by surprise by their own shareholders – shareholders who weren't what they seemed, due to the practice of stock lending. Picture Elon Musk in a purple robe, punctures in his back, or Gavin Darby of Premier Foods[1], or the board of British engineer GKN. Brutuses with knives abound.

The Romans also used to say "Fama Volat" (the rumour has wings), but the fleetest of foot Marathonian messenger had nothing on The Internetus today: a misleading story will travel round the world in seconds, encouraging those betting on a company's demise; the short position grows, the shares fall further. At the AGM some of the voting shares can be in the hands of people who do not have the best interests of the company at heart. Brutuses with knives abound.

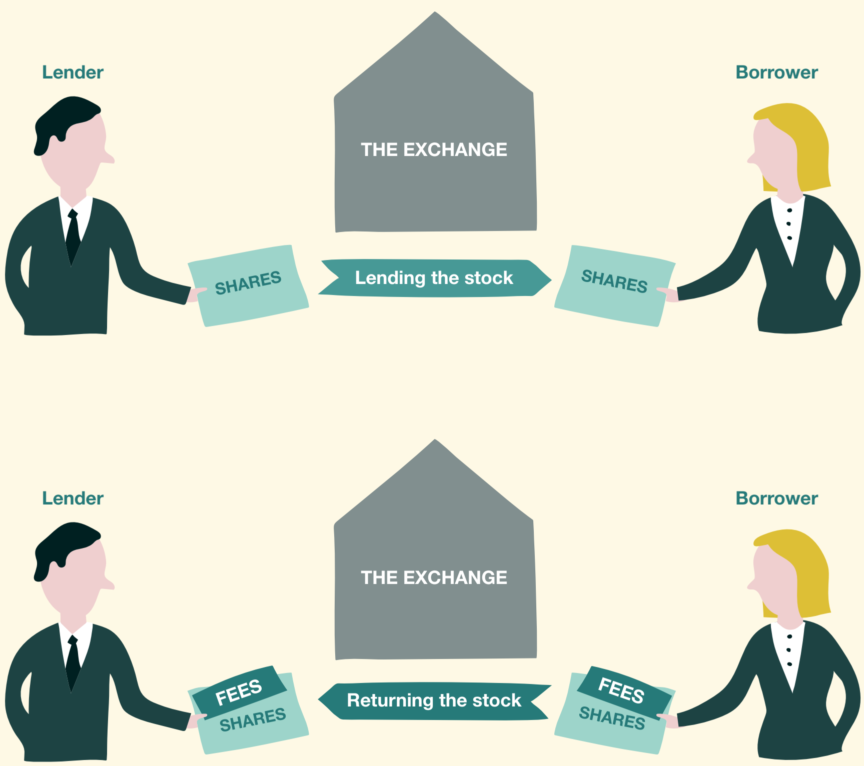


1. Darby went from a 99.5 per cent approval one year to 41 per cent opposition to his re-election the next. While his company Premier Foods was certainly not shooting the lights out, a major reason was that Oasis, a hedge fund, had conducted an aggressive attack campaign amassing one fifth of the voting shares, many of them on loan.

A WIDESPREAD BUT QUESTIONABLE PRACTICE

But what makes such dramatic scenarios possible in the first place is the practice of stock lending. Many institutions, often pension funds, believe they can slightly improve their returns by lending out their stock for a small fee and then having the collateral received re-invested for a modest cash plus level of return. On one level this is factually true, but we believe stock lending is a practice hitherto described in rather Panglossian terms to those that use it, and whose true downsides are rarely disclosed.

Stock Lending



So we come to bury stock lending, not to praise it. Our cards are explicitly on the table here: this is not supposed to be a balanced, discursive paper on the pros and cons of stock lending. It is – unashamedly – something of a critique of what we consider a dangerous and potentially damaging practice that conflicts with fiduciary duties in some serious ways.

Ironically, a one-sided paper may actually create a bit of balance on this subject – pension institutions have mainly been told the positives ("it's a nice little earner with almost no risk"), and the caveats that are dutifully included miss out some crucial points.

So we want to talk about two downsides to this practice which are rarely, if ever, mentioned: most importantly, the transfer of voting rights; but also share price warping. Before we get to these issues, we need to scene-set with a few paragraphs of context.

At Baillie Gifford we run dozens of pooled funds, along with several hundred segregated mandates for clients around the world. None of our pooled funds, where we set the rules, lend out stock. We also stick to long-only mandates. So you may read this paper with a talking-their-own-book cynicism, but on disapproving of stock lending we at least don't stand accused of hypocrisy: we don't lend, and we don't short.

Amongst our segregated clients, where they make the choice, quite a number do lend out their shares. 173/360 portfolios, to be precise. The reason clients give for having the lending programme is almost always to produce a bit of income in what they see as a very low-risk endeavour. We hope this paper will give our clients who do lend – and those who may be considering it – some pause for thought.

Our clients are fairly representative of the broader industry. Stock lending is a big business. About 70 per cent of US mutual funds and 30 per cent of European pooled vehicles lend out their stocks. About $20 trillion of assets are available for lending and about $2.3 trillion are out on loan per day. Stock lending generated almost $10 billion in revenues during its previous peak before the global financial crisis; it then declined for a few years due to the unforeseen experiences lenders had in 2008 (many put the collateral from lending into mortgage-backed securities, others had Lehman Brothers as a counterparty). But time heals and 2018 looks like being the first year that stock lending revenues will out-strip 2007. A good time therefore to have a look at this area again.

So what is the downside to stock lending?

MINIMAL GAINS

Well, the first downside is that there is hardly any upside to it in the first place. What follows are some figures directly from the website of a super-giant asset manager who has been stock lending on its funds since 1981, without a down year. Please note: these are the facts as they state them, but just in case they ever read this and don't like the tone let's call them Rocher-Noir asset management.

What do they mean by adding value through stock lending? Well, for the calendar year 2017, just over half of their funds added…less than 0.01 per cent return from stock lending. One-third of their funds added between 0.01 per cent and 0.05 per cent, one-tenth of their funds added between 0.05 per cent and 0.10 per cent, and one in 33 of their funds added more than 0.1 per cent from stock lending.

In anybody's terms, these gains range from small to very small. Even if you are in the highest performing decile in terms of what stock lending added, you're looking at maybe something approaching 0.1 per cent, and most funds are far less[2]. Therefore, if there is any downside to stock lending it's going to wipe out these modest gains. In the well-known cartoon, note that our resolute stock lender is not picking up gold ducats in front of the steamroller; it is pennies.

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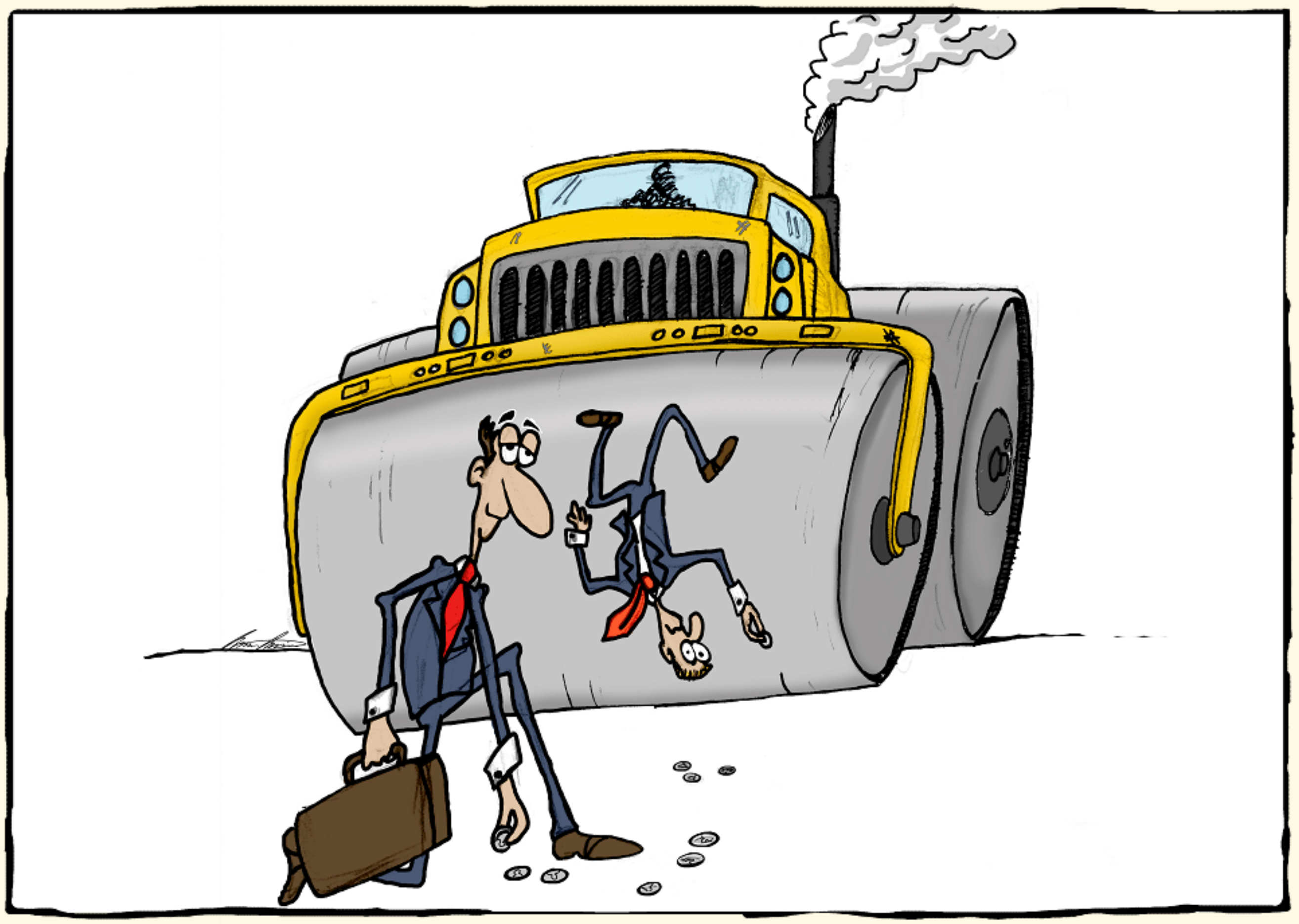
Given the extra return to be eked out from stock lending is so small, why is lending so popular with clients? Amateur psychology perhaps, but in a Rumsfeldian milieu where nothing is knowable for sure and every prediction of the future is uncertain, it is perhaps unsurprising that something that appears certain – a little extra return, whatever is happening in equities or economies or politics – proves disproportionately alluring. A pension fund board can point to a hard number of dollars it has made from lending in any given year. No concrete downside is evident – the potential or latent downsides are hard to quantify, and seem remote, even unreal. To some degree the popularity of stock lending amongst clients is understandable.

2. At the extreme though, Forbes magazine trumpets 16 out of 737 ETFs for being zero cost in 2017 thanks to lending out their stock so enthusiastically. Like a child showing off on a bike they can shout "Look Mum, no fees…!" Splat.



Not gold ducats.

FUND MANAGERS' SURPRISING MOTIVATION

But this doesn't explain why lending is also popular with the giant fund managers of the world. Surely managers of mutual funds like Rocher-Noir wouldn't encourage a practice that might make it harder for their funds to actually outperform?

Or would they? In 2017, Rocher-Noir themselves made several $100 million from lending out its clients' stocks.

How so? Well, most of the time a portion of the revenues generated from stock lending are kept by the fund manager. Aha! The portion varies, but typically the mutual fund manager keeps between one-third and half of the revenues derived from lending out its clients' stocks, though notably – and unsurprisingly – Vanguard passes on all the revenues from stock lending to its clients. So it turns out that stock lending can be a nice little earner for the fund manager too. At a time when management fees are (rightly) under more pressure than ever before, one imagines more than a few fund managers will be quite cherishing of their portion of the lending revenues, as fund managers like things they can count on too.

There is also a bit of icing on top of that cake for the fund houses – read the small print and you'll see the fund manager also charges a fee (presumably very small but I couldn't see the number) on the money management of the collateral that is put up by the borrowers of the clients' stocks i.e. the fund house chooses which money market fund, or low risk vehicle, to put the collateral in and they charge you for this service too. So clients pay:

1. A management fee for running the fund,
2. A portion of revenues to the fund manager generated from the lending of their own stocks from that fund, and
3. A fee for the management of the collateral ascribed to the stocks that are leant out.

Still no customers' yachts in the harbour then?

Now, the potential downside to stock lending that is always acknowledged – and here is no different – is along the lines "there is a small risk when we reinvest the proceeds of the lending, and a small risk of counterparty default, but we're insured for these eventualities and we manage it with skill and years of experience". This is probably fair enough as a description – in 2008, losses occurred since some of the collateral from lending had been parked in 'AAA-rated' mortgage backed securities. And lending losses also occurred since Lehman Brothers was a big counterparty to many of the lending trades. But those were exceptional times – let's say for the sake of argument the credit crunch was a one in 20-year event. The rub is that if you're only making a 0.05 per cent annual increment from lending you need a lot of okay years to make up for the nasty-surprise one.

But, coming back to our initial thesis – there are two downsides to lending that never seem to be mentioned, and which put together represent something of a bi-turbo attached to our figurative steamroller.

FIDUCIARY CONFLICT – VOTING

One of our most important fiduciary duties is to vote the shares that we own at shareholder meetings. We take this dead seriously, and have done so for many years. We don't outsource voting to any third party, and we think the whole exercise should be investment-led. This is an era when engagement with companies, and walking the walk on voting, should be truly core to what any active manager does, and to what any long-term thinking asset owner should seek to do.

For an engaged active manager, it can be disappointing when not all our clients give us the right to vote their stock – that would always be our preference. About one-third of our clients don't give us the right to vote, but there are several strategies behind this – some clients let us vote if we contact them to say "this is a very important issue" for example, while some have large stock holdings in their own right and have good reason to believe they take voting very seriously themselves.

But, where we do have the right to vote shares, it can be extra frustrating when stock lending comes into conflict with this fiduciary duty. All clients may not be aware that when they lend out a stock, the voting rights temporarily transfer to the borrower too. Thus, when a shareholder resolution is announced, the fund manager with a conscience, who takes voting seriously, has to recall the stock on loan, sometimes in quite a hurry, to then be able to vote it. And it doesn't always go smoothly.

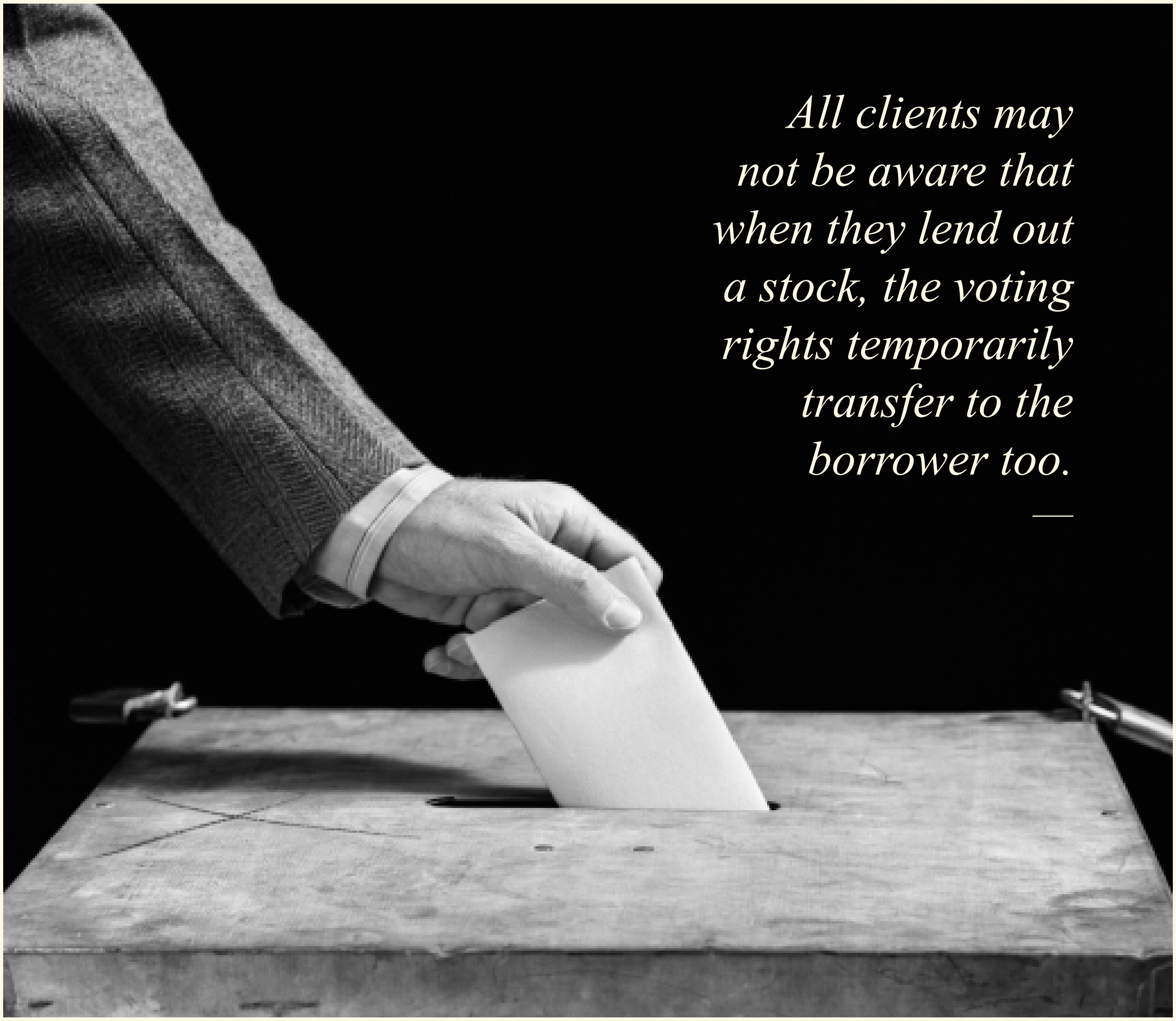
We recently had such an experience with one of our large UK holdings, ASOS, where we were unable to recall a number of our clients' shares in time[3] to vote on an important resolution. It also happened with Tesla both this year and last (one of our large American clients, despite its best efforts, was unable to recall any shares at all). What we find very difficult to understand is this: recalling stock in order to trade that stock is automatic and fairly painless; why should the process to recall the same stock in order to vote it be so much more laboured and opaque? Stock recall for voting needs to be standardised and automatic too (this is something we intend to highlight to regulators).

Tesla, of course, deserves a few lines to itself – unsurprisingly, our clients who do lend out stock have long been quite enamoured with Tesla as a stand-out source of lending income. The short position on Tesla has not been below 15 per cent of the shares outstanding in the last five years, and has climbed as high as one-quarter of the total shares outstanding. Quite why so many 'shorts' insist on impoverishing themselves remains a mystery, but they are perhaps hoping that if they can sap enough confidence from Tesla's suppliers, customers, and bondholders through vociferous shorting, maybe they can change the narrative itself – to be precise in Tesla's case, keeping the share price below $361 stops the convertible converting.

There has concurrently been a real danger with Tesla (and other shorted companies) of 'empty voting' – where the short sellers exercise votes on resolutions using stocks they temporarily 'own'. Given the enthusiastic vitriol the company seems to attract, and that these temporary owners wish ill of the shares, we find it more than irritating that so many of our clients' shares end up in these hands.

Already the rushing around recalling shares isn't ideal, but there is a timing problem on top of this that can make the voting conflict particularly acute. In the US (also in Japan and Korea), the record date is sometimes set at a date prior to the communication of when the next shareholder vote will be.

3. One issue is that the custodian bank sometimes needs to hear from our client to recall the stock, not just from us as the fund manager. We've tried to make this more efficient by automatically including our clients in any recall requests but it's still another link in the chain.



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So, say a company writes to its shareholders on 1 May and says “there will be an EGM on 5 June to decide [new exec remuneration] and the record date has been set at 15 April”. The key question is – who owned the shares on 15 April? You can recall the shares with alacrity on 1 May or shortly thereafter, but it makes no difference – if Gekko and Partners Hedge Fund owned them on 15 April, they get to vote your shares. And what if the said hedge fund wishes an adverse outcome? The most famously quoted example here is rather out of date, when a hedge fund, Laxey Partners, borrowed stock from Hermes (a leading light in governance in recent years – red faces there at the time no doubt) to vote against British Land in 2002. A more recent example was the Melrose/GKN takeover in the UK earlier this year. But the point is that, even if these scenarios are quite few and far between, it only takes one of these voting incidents to cast a fiduciary pall over those 0.05 per cent p.a. enhancements from lending.

FIDUCIARY CONFLICT – SHARE PRICE SELF-HARM

The other downside that is never mentioned is the impact on share prices. This is because it is impossible to quantify, so what can one actually prove, and surely it doesn't matter for long-term shareholders like us anyway? There are a couple of flaws with taking this defence of lending.

Predictably, the money made from lending out shares is concentrated round a very small number of stocks at any given time. We alluded to Tesla earlier – in the last few months there have been times when our clients would make more money lending out Tesla than all the other shares in our global equities portfolio put together. And while it is almost impossible to quantify how much the share price of any stock has been warped by short-selling pressure, it is hard to dispute the contention that distortion occurs.

We don't think the temporal fall back – "it's only for a brief period and you're the long-term guys so what are you worried about?" – is solace enough. The first reason is because clients ask for redemptions at short notice from their mandates almost all the time, so even a short-term price impact on one stock when one or more clients are redeeming would do more damage than a 0.05 per cent annual income boost to those same clients. Take a hypothetical, approximate, but arithmetically relevant example: a client redeems 20 per cent of the global equities mandate at short notice. Tesla is a 6 per cent holding in that mandate but the share price is 10 per cent lower, with short pressure in anticipation of bad results (we often see a roughly 10 per cent 'pop' on short covering). That would suggest that the client loses about 0.12 per cent in redemption value due to Tesla shorts, wiping out annual lending income in one go.

Second, short sellers like to portray themselves as 'unbiased seekers of the truth', but their interest is to profit from falling share prices. Sometimes these share prices need a nudge in the right (i.e. down) direction. We've seen articles and so-called research notes comparing Tesla to Enron and Worldcom. We don't think Tesla needs more funding, but a reflexive negative feedback loop started by vested-interest-ill-wishers could lead to customers cancelling orders and then to an actual funding crisis where there wasn't one? It's not out of the question. Entrepreneurs of transformational public companies, who shake up established orders, need to run a gauntlet like the now famous iguana in *Planet Earth 2*, hounded on all sides by the racer-snake-shorts.

Entrepreneurs of transformational public companies… need to run a gauntlet like the now famous iguana in Planet Earth 2*, hounded on all sides by the racer-snake-shorts.*

This share-price-warping-from-lending downside is that it is almost impossible to quantify other than a rough guess (see above), whereas the income from lending is clearly countable. But we would contend that just because the downside is fiendishly hard to quantify doesn't mean it doesn't exist. And it only needs to happen once in a long while (just like the voting example) to negate years of modest lending income.

One last ironic aside on stock lending and share price repercussions. Many of our clients worry about volatility quite a lot. More than they should do, really. Even when volatility is very low by historic standards[4], as it has been for most of the last decade, they think 'vol' remains high and must be dampened. Lending out stock almost certainly increases the volatility of the shares they actually own.

We're rooting for the iguana.

4. Since 2003, with one big spike in 2008, volatility has averaged below 20 more than 85 per cent of the time. Since the second half of 2009 volatility has been consistently very low.

REGULATION AS PRAETORIAN GUARD?

It is probably unusual for a fund manager to yearn for more regulation of our industry. But stock lending is something of an unregulated sub-industry in fund management, and some regulation is on its way. On the whole, we would welcome this development, though it is only likely to occur in Europe. From as early as September 2019, the SFTR (Securities Financing Transaction Regulation) is going to require a detailed daily report from lenders. No doubt it will be quite annoying and time consuming to put together this daily report. Who knows what the consequences will be, hopefully greater transparency will be one, but if managers have to fill in lots of spreadsheets every day, it’s quite possible they will seek more compensation for doing so. Unfortunately, nothing from a regulatory standpoint is on the horizon in America, where lending is more prevalent; opacity in the biggest market will remain.

CONCLUSION – A PLEA

We wish to be the best stewards of long-term capital for our clients that we can be, exhibiting the highest fiduciary duty at all times, and generating the best long-term returns for our clients that we can. We think that widespread use of stock lending makes this goal slightly harder to achieve, and on balance probably harms our clients' interests. Stock lending comes into conflict with the principle of stewardship through complicating, and even impinging on, voting, and it almost certainly adds to warping share prices. These downsides (plus the more often cited re-investment and counterparty risk) are not justified by the very modest, if alluringly tangible, revenues generated from lending. And, while other managers may not openly disapprove of lending in the way we are doing here, keep in mind that many of them keep some of the revenues from lending out your stocks for themselves.

We may lack the spellbinding oratory of Mark Anthony, but to our clients who run lending programmes, we ask you in reading this paper to lend us your ears, not others your stocks. To our clients who are contemplating stock lending, we ask that you acknowledge the full flipside of the story before making a decision. And to our clients who don't currently give us permission to vote, we ask for the chance to do so in the future.

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Scott graduated MA in English Literature and French from the University of Edinburgh and gained a Post Graduate Diploma in Translation from University of Paris. He joined Baillie Gifford in 1996 and worked in the North American and UK investment teams until 2003, when he moved to the Clients Department as a Director with responsibility for overseas clients. Scott became a Partner in 2007 and is a member of our CDMG (Clients Department Management Group). He is also a member of the Strategic Leadership Group.

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