



Proxy Voting and ESG Investing Interactions with Different Asset Classes

ESG & Sustainability Transformation

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Voting:

As we have discussed in previous articles, shareholders have voting rights at Annual General Meetings (AGMs) and Extraordinary General Meetings (EGMs), and in some markets, sometimes at other investor meetings. In most cases, voting rights are proportional to the percentage of shares owned in the company, and resolutions are usually passed when more than half of those voting in favour at a vote. In some cases, special resolutions require the support of 75% of the votes cast, and there are unusual cases where the number of votes cast exceeds a threshold in terms of total share capital (and more rarely where the number of shareholders is significant). Institutional investors typically vote in favour or against, although in many markets there is scope for conscious abstention (for example, in the UK these votes are collated although they are not legally considered votes). This is considered an active decision rather than simply the absence of a vote. Abstention can sometimes be a useful tool in the engagement process when an investor does not have a fixed view on an issue but certainly does not want to be in a position where they may later be prevented from criticizing an action that they actually supported, through voting.

Due to the public nature of general meetings of companies, where the results are announced publicly by the company and the events themselves are often made available to the media, voting decisions are often the most visible element of the stewardship and engagement role. As a result, they attract disproportionate media attention and large negative votes often receive significant media coverage. As a result, fund managers are often held accountable, both to the public and to their clients, for individual voting decisions.

Voting is often referred to as “proxy voting” because investors rarely attend the meeting where the vote takes place, but instead appoint an individual as a proxy to vote on their behalf (in most cases this will be the chairman of the company, although anyone present at the meeting can be appointed). The votes belong to the legal owner of the shares, which may be a custodian or trustee or some other intermediary, meaning that even an institutional investor will often need various formal paperwork to attend the meeting and vote, especially one that clearly identifies the individual directly representing the investor at the meeting.

With large asset management portfolios and AGMs often occurring in a short space of time (months in some markets, notably Japan, where thousands of AGMs are held in just a few days), resources are a particular issue when it comes to voting. Institutional investors often rely on proxy advisers to help process votes and provide advice. There are two companies that currently dominate the market for this service:

- ISS, with around 80% of the market share; and
- Glass Lewis, with most of the remaining 20%; along with
- A few much smaller competitors, with some small market shares, particularly in some local markets.



Proxy advisers are often criticized by investee companies for taking seemingly narrow approaches, for being inflexible in their voting, and for not facilitating the “explain” aspect of “comply/apply or explain.” But most investors would argue that the role of advisers is less flexible and more focused on general guidance, and that investors should demonstrate a deeper understanding of individual companies and respond appropriately to explanations. The extent to which investors actually use their own judgment and avoid relying on their proxy advisers—especially in smaller stocks outside their home markets—varies.

Voting is an important tool for an active investor and any voting decisions should be consistent with the investment thesis for the holding and any asset management program the organization has in relation to the company. Thus, for example,

- If there are concerns about the capital structure and financial health of the business, investors should pay close attention to votes relating to dividends, share repurchases, equity issues or debt expansion.
- If there are concerns about the effectiveness or diversity of the board, these should be reflected in voting decisions on the re-election of directors (and in particular in relation to members of the nominating committee).
- Concerns about the independence or effectiveness of the audit process should be taken into account when voting on the reappointment of auditors, auditor compensation and reappointment of audit committee members.

Given the level of attention paid to executive pay, it is perhaps unsurprising that investors are very interested in remuneration resolutions. In many markets, there are both non-binding annual resolutions to approve pay for the year and binding votes on forward-looking policies and any new remuneration plans. These are in addition to votes on the appointment of members of the remuneration committee.

Investors will also often reflect concerns about financial reporting or sustainability in their votes approving the reports and accounts. In most markets, this is a largely symbolic measure, but the message sent by voting against it can still be important. It is important to remember that although most resolutions are considered to be purely G matters (e.g. approving accounts and dividends, electing directors, related party transactions, appointing auditors and deciding on capital structure—issuing shares and authorising share buybacks), there is no reason why investors' decisions on such decisions should be driven solely by G considerations.

This can be seen, for example, in the recent debate about the inclusion of climate change issues in financial statements (financial statements at the back of the annual report, rather than the narrative report in the front half). In September 2020, investor groups representing over \$100 trillion in assets published an open letter calling on companies to follow guidance from the International Accounting Standards Board (IASB) and include material climate change issues in their financial statements, and to fully disclose their relevant assumptions. The investor groups also called on auditors to play a role in ensuring this was done, and said they expected the assumptions used to be compatible with the objectives of the Paris Agreement. Some investors are considering how their voting patterns might respond to any failure to heed this call from investors. In particular, some are likely to vote against reports and accounts that do not make it clear that climate change has been factored in or assumptions have not been disclosed. Some are considering voting against auditors of climate-sensitive companies that do not include climate issues in their audit



reports. And others are expected to vote against key directors of companies that do not show sufficient signs of climate awareness where they face major risks.

Any vote itself is rarely meaningful because there can be many reasons why an investor votes in a particular way. Therefore, institutional investors often have active programs to communicate to companies why they are voting in a particular way, either in writing or in conversation. Many seek to engage in active discussions with companies as they work toward their voting decisions (helping them tailor their decisions to the company's specific circumstances) and use this as an opportunity to explain the thought process behind any decision. This dialogue is a form of low-level interaction but will have only limited impact.

Although institutional investors are unlikely to attend shareholder meetings in person, asset managers should perhaps consider this opportunity more actively. Particularly in small and medium-sized companies, AGM attendance may be small or negligible, and investors may therefore have direct access to many directors at once, with ample opportunity for informal conversations. Furthermore, since the entire board typically attends most AGMs, these meetings can provide investors with unusual insight into board dynamics and the ease with which relationships are developed in the boardroom. Shareholder meetings often provide an opportunity for many board members to be formally questioned (typically, any committee chair will answer questions directly, as will the chairman and CEO; in some cases, the audit partner will also attend and may answer relevant questions). But many will find that the informal insights from actually participating in general meetings are just as valuable.

ESG Investing Interactions with Different Asset Classes:

While most asset management codes claim to be intended to apply to all asset classes, their language and approach seem to draw heavily from the world of listed equity investing. Our article will reflect a tendency to think primarily about public equity investing, but its application is much broader. That is because the codes (and this article) are written with principles that can be applied intelligently and intelligently across asset classes.

Many investment structures involve businesses investing in assets that in some ways resemble public companies, with direct management responsibility for direct real estate or infrastructure assets on their own boards and where directors and investors can interact. Private equity and other fund investment structures (including indirect asset or infrastructure investments) will often see the interface for investors working with the fund management organization rather than the underlying assets. However, the sense of accountability and the need for alignment arise as much in these relationships as in any corporate governance structure.

The concepts of engagement need to be applied differently to accommodate the circumstances and levers of influence available. Because engagement is often about influence rather than control, investors should have some scope to engage successfully regardless of the formal structure through which they invest.

Typically in more indirect, later investment structures, engagement issues are more about policy and approaches to ESG issues than specific concerns about individual assets, but if concerns about an individual asset indicate that policy approaches may not be what the investor expects, engagement may be very specific indeed. An interesting case study in this regard is the exclusion of private equity assets of gun manufacturers and retailers by some asset owners, most notably CalSTRS (the California teachers' pension plan, which has responded specifically to the number of school shootings in the United States). For



example, Cerberus allowed its investors, including CalSTRS, to divest their underlying stake in retailer Remington Outdoor in 2015.

While in these cases the investors typically do not have voting rights and there are no formal sanctions against the parties, the penalty of selling the position or being unwilling to invest in future opportunities is still there. This is clearly a strong sanction in most cases (especially if the asset owner is large) and is certainly enough to bring the concerns raised to the attention of the investor's counterparty.

Corporate Fixed Income:

Fixed income investors (e.g., bonds or loans) may be concerned about the possibility of default, but ESG factors can impact credit ratings and spreads, leading to short-term fluctuations in value. Companies that regularly raise capital in the fixed income markets are increasingly aware of investor interest in ESG as an important factor in pricing their debt.

ESG engagement is also important in private debt, private equity, and property and infrastructure investments. These investments are often illiquid, relatively long-term, and involve close partnerships between investors and investees. As a result, there are both incentives and opportunities for ESG engagement.

With respect to fixed income, PRI's ESG Engagement Guide for Fixed Income Investors: Managing Risk, Enhancing Returns recommends that investors prioritize engagement based on the following factors:

- Portfolio holding size;
- Lower credit quality issuers (with less balance sheet flexibility to absorb negative ESG impacts);
- Key themes that are material to sectors; and
- Issuers with low ESG scores.

The greatest opportunity to promote ESG disclosure and conditions may be at the pre-issuance stage. This can be difficult in fast-moving listed markets, but is easier to achieve in private debt issuances.

Investor interactions with corporate debt issuers are most commonly with the firm's treasury department rather than with senior management. In most cases, the dialogue involves strategy, risk, financing structure (especially where the proposed debt is within a debt hierarchy), and covenants and protections for debt investors. However, there is a growing risk conversation around ESG issues, and debt investors are finding that they may have some impact on the approach taken by fixed-income issuers.

This range of influence is particularly evident when debt investors join with equity investors (or when individual institutional investors combine their engagement methods in relation to an investment in a single issuer, regardless of the asset class and portfolio exposure it holds). There are cases where equity and debt investors are in direct competition with respect to the issue; for example, in the case of certain transactions or capital structures, or in the case of a company approaching insolvency. However, in most cases involving ESG issues in going concern companies, the interests of long-term investors (whether they are equity or debt) are aligned and will benefit if the company effectively addresses ESG issues.

Sovereign Debt:



Asset management engagement with sovereign issuers is likely to be much more limited. Here, only the largest investors have the ability to influence the stance of countries, and even then, the influence may be minimal. As a result, the ESG approach typically adopted in this asset class is one of screening or an ESG tilt into the investment process rather than engagement.

Having said that, there are early signs of steps to promote investor activity in this space, and PRI has produced guidance for those looking to engage with sovereign issuers. This guidance highlights the nascent nature of engagement in this investment space and focuses on exploring how engagement might play out rather than highlighting successful case studies. There is a particular focus on educating sovereign debt issuers about the value of green bonds and the strong market demand for such instruments.

The leading case study on sovereign debt commitments is the work of a group of 29 investors with assets of about \$3.7 trillion to encourage the Brazilian government to do more to curb deforestation of the Amazon rainforest. Reached out through Brazilian embassies in their home country, the group wrote to the government in June 2020 noting, among other concerns, that “Brazilian sovereign bonds are also likely to be considered high risk if deforestation continues.” At least some of the group are said to be considering divesting existing holdings and excluding Brazilian debt from their sovereign debt portfolios to reflect these concerns. Sadly, it's unclear whether this effort has had any positive impact, as other reports show that the rate of deforestation in the Amazon accelerated in 2020, reaching a 12-year high.

Private Equity:

In private equity investments, direct ESG engagement will be undertaken by the general partner (GP) rather than the limited partner (LP), although individual LPs may wish to engage with their GPs in the process of monitoring and acting on ESG issues in their portfolios. As the PRI ESG Monitoring, Reporting and Dialogue in Private Equity report notes:

The portfolio monitoring process itself has the potential to protect and enhance value, as a systematic approach to identifying material ESG issues, setting targets, and regularly tracking progress. It enables GPs to: identify anomalies and achievements; facilitate regular engagement with portfolio companies on these issues; and enhance the reporting activities of the company that may have implications upon exit.

Because private equity provides a form of equity ownership, the logic of extending the principles of the Asset Management Code to such investments may be more natural. That is especially true when companies are at an early stage and investors have more significant influence. The poor governance of some companies through the private equity system—for example, the public failure of WeWork’s initial public offering (IPO) was in large part due to poor corporate governance—suggests that ESG is often less effective in private equity companies than it would be if private equity investors were leveraging them.

Infrastructure:

Infrastructure investors must be exposed to ESG throughout the economic life of their assets. These risks extend beyond issues directly related to a specific asset, such as health and safety, supply chain and environment, to factors such as climate change, bribery and corruption and operating licenses. PRI (2018a) recommends that investors consider eight (8) potential mechanisms to act as owner engagement in infrastructure assets:



- Use ESG assessments made during due diligence to prioritize ESG considerations and the potential to improve returns, efficiency and risk management.
- Incorporate material ESG risks and opportunities identified during due diligence into the post-acquisition plan of each asset or project company and integrate this into asset management activities.
- Engage and encourage corporate management to act on identified ESG risks and opportunities using available mechanisms.
- Define and communicate ESG performance and performance expectations to infrastructure corporate managers.
- Ensure ESG factors identified as material during due diligence are clearly incorporated into asset-level policies.
- Support a Governance framework that clearly outlines who is accountable for ESG and sustainability.
- Set performance targets to preserve or improve environmental and social impacts, including regular reporting to the board and investors.
- Where possible, provide ESG information and expertise to the asset management or project company to help it develop capabilities.

Like private equity and real estate, many infrastructure investors will work through specialist managers. In these situations, it is the investor's responsibility to monitor and engage with the manager. AustralianSuper, one of Australia's largest pension schemes, has been investing in infrastructure since 1994. In a 2012 case study by PRI, AustralianSuper reported that one of its infrastructure managers used a detailed Global Reporting Initiative-based questionnaire to analyse the ESG impact of each of its 28 existing assets. Analysing and benchmarking these assets allowed the fund manager to:

- Improve governance at each board it serves;
- Arrange for four Australian airports to work together to develop market-leading health and safety protocols based on each airport's practices; And
- Measure electricity, water usage and carbon emissions of each asset on a regular basis, allowing for the identification of energy savings across multiple assets.

Property:

As with fixed income investing, there is clear evidence of a positive impact of ESG on returns from real estate investing. A 2015 study by Friede, Busch and Bassen found that 57% of equity research showed a positive impact, although the positive rate for bond research was 64%, rising to 71% for real estate investments.

A 2014 INREV study found a 2.8% difference in returns between the top 10% and bottom 10% of real estate assets rated by the Global Real Estate Sustainability Benchmark (GRESB). Regulatory changes are also driving the need for greater engagement with ESG in the real estate sector.

Investors should engage indirectly by requiring their managers to report on the frameworks and metrics they use to monitor asset holdings. Additionally, the UNEP Financial Initiative et al. recommends that real estate stakeholders:

- Engage directly or indirectly in public policy to manage risk;



- Support research on ESG and climate risk; and
- Support industry initiatives to develop resources to understand risk and integrate ESG.

Fund Investments:

For funds as an asset class, interacting with fund vehicles, including any underlying assets, can sometimes be a little more complicated. However, there is usually a fund board that represents the interests of investors and there can be interaction. Investors are often kept away from the underlying assets, but their role is to hold fund managers accountable for their own investment and asset management efforts. Bridging the mandate gap for these types of vehicles can be more difficult and require more effort, but as long as investors keep this in mind, the interaction is likely to work.

To learn more about ESG and sustainability-related models, please contact [YTT Consulting!](#)

