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Why ESG Investors Need to Practice Asset Management Rights & Obligations and Interact, Especially During AGMs

ESG & Sustainability Transformation

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Stewardship is often used as an umbrella term, encompassing the approach investors take as active owners of the companies and other entities in which they invest through voting and engagement. Voting is one aspect of asset management and tends to focus on corporate governance issues raised at general meetings of shareholders (AGMs). Engagement is the way investors exercise their stewardship responsibilities in line with Principles for Responsible Investment (PRI) principle 2 ("We will be active owners and integrate Environmental, Social and Governance (ESG) issues into our ownership policies and practices"). It is often described as purposeful dialogue with a specific objective; That purpose will vary from engagement to engagement but is often related to improving the business performance of companies, especially in relation to the management of ESG issues.

Stewardship should be the outcome of investing. In contrast, action is often a specialized form of such engagement and stewardship, where an investment institution initiates an investment with the aim of generating superior investment performance through driving change in a company's governance, capital allocation or business practices. Most commonly associated with activist hedge funds today, the increasingly short-term, value-extraction rather than long-term value creation mindset is the driving force behind most engagement.

In this article we will look at stewardship and engagement and then discuss different styles of engagement. We review the framework of guidelines and rules that guide the approach to asset management and discuss how the interaction can be most effectively implemented.

What is Asset Management? What is Interaction?

Asset management is a strange word that is not easy to translate, but it is commonly used globally to describe the responsibilities of institutional investors. It is a term with a long history. The word "steward" is derived from two Old English words ("stig" and "weard") describing a guardian of a house to protect the owner's assets. In the Middle Ages it was the house and its real estate, in the 21st century it is assets purchased on the financial markets. The manager is the owner's representative, responsible for acting in the owner's interests and delivering long-term returns and value from their assets.

Asset management is a broad term for an investor who acts as a good steward of long-term assets, standing in the shoes of their clients to ensure that value is added or preserved over time.

When the first property managers emerged, the concept of fiduciary duty was developed. A fiduciary duty is the duty of a person (a trustee) to care for the property of another; a person with a fiduciary duty must seek to protect and enhance the value of the property they have been entrusted with so that they can return it to its owner. As the owner's agent, caring for the property on behalf of the owner, the manager must always feel the burden of a fiduciary duty.

Asset management is the process of intervening to ensure that the value of assets is enhanced over time, or at least not diminished through neglect or mismanagement. This can include buying and selling assets to maintain value across the asset pool, as well as

acting as a good asset custodian. Engagement is one aspect of good asset management; it is personal intervention in specific assets to preserve and/or enhance value. In modern investment terms, this is dialogue with the management and boards of investee companies and other assets. Voting is a particular form of engagement. It is the most visible form because public company annual general meetings (AGMs) are public events and many organizations today make their voting actions public (some even before the relevant meetings). However, it is essentially formulaic in nature as the resolutions that shareholders vote on are limited by law. The interaction is much broader than just voting.

Engagement is an active dialogue with a company where the investor is seeking specific change. This can often be a lengthy process and involve repeated contacts with senior representatives of the company. With a focus on preserving and enhancing long-term value on behalf of the asset owners, engagement can cover a full range of issues that impact the long-term value of the business, including:

- Strategy;
- Capital structure;
- Operating performance and execution;
- Risk management;
- Remuneration; and
- Corporate governance.

ESG factors are clearly integral to these issues. The opportunities and challenges presented by ESG developments need to be reflected in the strategic thinking of the business. Similarly, a full assessment of performance must include not only financials but also key areas that are relevant to all stakeholders of the company:

- Highlighting the long-term health of the business, such as relationships with the workforce;
- Establishing a culture that supports long-term value creation;
- Dealing openly and fairly with suppliers and customers; and
- Having effective and appropriate environmental controls.

A full understanding of the key risks facing a business will always include ESG factors; and clearly remuneration and governance are integral to the G pillar of ESG

Asset management and engagement are beneficial because they enhance shareholder value and assist investors in fulfilling their fiduciary duties — indeed, for many, asset management is simply a fiduciary duty. When done well, asset management and engagement encourage increased information flow between investors and investees as they discuss and debate issues. These exchanges allow them to learn from each other, build relationships, and, most importantly, encourage change as shareholders communicate their views on key issues facing the company.

Since asset management is a reflection of fiduciary duty, it should be actively considered by any party with a fiduciary duty. This will include most parties in the modern investment value chain, from the primary beneficiary to the asset owner (pension fund, insurance company or other type of fund) to the fund manager and those entrusted with investing the

assets. Any of these parties can perform asset management functions, but in practice the role typically falls to the largest aggregate party – usually the fund manager. Only the largest asset owners will seek to perform asset management activities themselves. Asset management expectations are typically set out in an investment mandate – a contract between the asset owner and the fund manager.

In a 2018 report, the Principles for Responsible Investment (PRI) highlighted three ESG engagement drivers that they believe create value:

• Communication drivers (information exchange);

• Learning drivers (knowledge building); and

• Political drivers (relationship building). Developing these drivers requires investors to move beyond a superficial understanding of the company and its operations. Unless managers are committed to building communication, relationships, and a desire to learn, engagement is unlikely to be successful. To be successful in engagement, investors need to respect the uniqueness of the company, seek understanding and relationships, and not simply declare that things need to change. This means that good engagement is time-consuming and tailored to each company.

Different investors may have different definitions of what successful engagement looks like. The conventional definition of interaction—a purposeful dialogue with a specific goal in mind—assumes one important thing: that participants set goals for their interaction at the beginning of the interaction, and that the purpose of the dialogue is to achieve those goals over time.

While different investors set different goals and measure their performance differently, an engagement is only successful to the extent that it delivers on pre-agreed objectives. Financial success in terms of business performance or share price performance, may therefore occur but will always be a sub-context of the first measure of success. This is because many engagements are more about protecting value than increasing it, and it is impossible to know what might have happened without the engagement.

This mindset of measuring success against the delivery of pre-agreed objectives is very much in line with the new thinking that has been published in the UK Asset Management Code (2020). The Financial Reporting Council, in its Code, has repeatedly discussed the need for signatories to disclose the outcomes of their engagements and the specific benefits of asset management to their clients and ultimate beneficiaries. The Code also repeatedly uses the word "outcome" to describe "the achievement of objectives that benefit the client."

As with ESG and investment performance, there is growing evidence that engagement adds value to a portfolio. One of the earliest papers to provide a detailed academic analysis of the impact of engagement was "Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund". This study looked at the early years of the Hermes Focus Fund (launched in late 1998) and reviewed the fund's first 41 investments. They studied the internal records of the Focus Fund team's activities and examined their impact both in terms of implementing change in the companies in question and in delivering returns to investors. To assess this, the study sought to define successful engagement by analysing the objectives set for each engagement initiation. It found that the majority of these stated objectives were achieved, with an overall success rate of 65%, with the greatest success in restructuring and financial policy and slightly less success in relation to board changes. Ironically, the lowest success rates were found in areas where shareholder

engagement is more frequent, with only 25% of expected remuneration policy changes being achieved, and only 44% achieving improvements in investor relations. While analysing this success, the study also found that the fund achieved positive financial returns. At the time, the fund's overall performance of 4.9% net per annum exceeded the FTSE as a whole; 90% of this excess return was attributed to activists.

In Active Ownership, the engagement profile of another (anonymous) fund manager was studied in depth, looking at the years 1999-2009. This study looked at investments that were less hands-on and more of what would today be considered standard ESG engagement and management. One benefit of studying this engagement style is that the number of cases covered in the study is substantial. Although it only looked at US-based activity by a fund manager, it included over 2,000 engagements, involving over 600 investee companies, and had an overall success rate of 18%.

The core finding of this study is clear: Successful engagement leads to abnormally positive financial returns. For example, for successful climate engagements during the study period, excess returns in the year following engagement were over 10%, and nearly 9% for successful Corporate Governance (G) engagements. Typically, the time from initial engagement to success was 1.5 years, requiring two or three engagements. On average, ESG engagements generated abnormal returns of 2.3% in the year following initial engagement, increasing to 7.1% for successful engagements, with no adverse reaction for unsuccessful engagements.

More recent research shows that ESG engagement leads to a reduction in negative risk, and the stronger the effect, the more successful the engagement. In this case, the strongest impacts relate to Governance (which is also accounted for in the majority of engagements) followed by Social issues (as long as they are also related to Governance work).

These studies show that engagement – if done well, focusing on material and relevant issues and pursuing them with persistence – can be effective. Companies that receive engagements make changes in their behavior towards ESG factors, and this leads to increased value.

Engagements are also effective, often to inform investment analysis. It helps to add to the investor's understanding of the business model's potential to adapt to changing business environments and growth expectations and the readiness of a particular management team and board to strategically address these challenges. Therefore, for many investors, engagement is an important part of active investment decision-making.

Why Engage?

Engagement helps investee companies understand the expectations of investors (and potential investors), allowing them to shape a long-term strategy that is relevant to them. Engagement also allows companies to explain how their sustainability approach relates to their broader business strategy, and can provide an opportunity for companies to comment on ratings or scores (from rating agencies) that are driven by templates that they feel do not reflect the complexity of the issue.

Engagement also explicitly allows investors to work closely with investees over time on specific Governance, Social or Environmental issues that investors consider to pose a risk to the value of the business. By working with the management of companies – individually or collectively – institutional investors can influence companies to adopt better ESG practices, or at least to abandon poor practices.

The Investor Forum, a UK group set up to facilitate collective dialogue between investors and investee companies, describes the interaction as "active dialogue with a specific and purposeful objective... the underlying aim... must always be to preserve and enhance asset value".

In its 2019 white paper, Defining Stewardship and Engagement, The Investor Forum provides a framework for understanding the nature and key elements of asset stewardship. By defining stewardship as the assets entrusted to an organization, the framework deliberately frames stewardship in the context of fiduciary duties. Trustees (of pension funds or other assets) and directors fully understand that they are fiduciaries because they have a duty of care to care for assets on behalf of others. Because they are also entrusted with assets, similar fiduciary duties apply to investment institutions. The Forum argues that asset stewardship is one aspect of the performance of those duties.

Of particular importance in this analysis is the contrast it draws between monitoring and engagement dialogues. As the article points out, monitoring dialogues are conversations between investors and management to gain a fuller understanding of performance and opportunities, typified by detailed questions from investors and potentially informing decisions to buy, sell or hold investments. In contrast, interactive dialogues are conversations between investors and any level of the investee entity (including non-executive directors) that involve a two-way exchange of views, such that investors express their views on key issues and, in particular, highlight any concerns they may have. This two-way dialogue and clear expression of views is necessary for the interaction to deliver the intended outcomes, in terms of changing corporate behaviour, etc. If the interaction is to be effective in producing change outcomes, it requires a clear objective that has been set at the outset.

The difference between monitoring and real engagement dialogues illustrates the ways in which asset management can sometimes be ineffective or inappropriate. There may be cases where engagement is directed at companies that are unlikely to change and have no intention of engaging in a productive dialogue with their investors. Engagement with these companies has very limited benefits, but some clients may suspect that it is an excuse to continue holding a company that is not suitable for the portfolio but that the portfolio manager wants to continue holding for performance reasons. This is not considered real engagement, but rather a cover for investment decision-making.

The opposite can also occur: engagement as an investor’s response to poor investment decision-making. Very often, the desire to engage arises from a decline in the stock price. Active fund managers may then become concerned about issues that may have been apparent for some time but may have been overlooked because of the positive performance of the share price. Experience tends to show that such knee-jerk engagement is less likely to be effective than consistent messaging over time (where the intensity of engagement may increase in times of stress, but the messaging does not just start at those times). Key hallmarks of truly successful engagement include being clear and consistent about objectives and ensuring that it is clear that investors are communicating messages to the company and not just seeking information from it.

Achieving specific outcomes is at the core of the “why” of engagement. Effective engagement creates change, and if the intended outcomes are well chosen, that change will preserve and enhance long-term value at the firm that the engagement is based on.

Engagement thus delivers on the promise of a fiduciary duty: to preserve and enhance the value of the assets that the investor is overseeing on behalf of its clients and beneficiaries.

As well as the need for clear, focused goals for implementing change, the study also identified a range of other characteristics of effective engagement. These are a set of "high-quality action characteristics" that require high-quality actions to be:

• Set in the appropriate context of long-term ownership and focused on preserving and creating long-term value, so that the engagement is consistent with the investment thesis;

• Framed by a strong understanding of the nature of the company and the drivers of its business model and the long-term opportunities for growth and prosperity; Recognize that change is a process and that, while it may sometimes require haste, it should not be rushed inappropriately; Use consistent, direct and honest messages and dialogue;

• Be appropriately resourced so that it can be delivered professionally within the context of a full understanding of each company; Use resources effectively to cover as wide a range of engagements as possible while using all available tools, including collective engagement; and

• Involve reflection to learn from lessons to improve future engagements.

These characteristics will be explored through case studies and discussed further below.

Examples of Engagement in Practice:

A PRI case study describes Boston Common Asset Management's long-term engagement with VF Corporation (VF Corp) around water risks in its cotton and leather supply chains. This multi-year engagement — during which Boston Common filed and then withdrew a shareholder resolution (withdrawn in response to the company's commitment to address the issue) — saw VF Corp improve its reporting, conduct a material risk assessment, and sign up to the Better Cotton Initiative's best practice standards.

Hermes EOS' engagement with Siam Cement saw the company improve from level one (the lowest score) to level three in the Transition Pathway Initiative (an initiative by asset owners to assess companies' preparedness for the transition to a low-carbon economy). In early 2018, the investment firm met with senior management to discuss its 2020 emissions targets. It then held a TCFD (Task Force on Climate-Related Financial Disclosures) workshop with senior executives at Siam Cement to share industry best practice and encourage the company to improve its physical risk assessment of its assets, engage in industry collaboration and establish a group-wide climate governance mechanism. The company has now committed to the Paris Agreement global temperature cap target, expanded scenario planning and improved climate-related governance and business management.

In 2018, the Investor Forum worked with its members to address concerns around Imperial Brands' strategic direction, operational execution and disclosures. The company's chairman was "prompt and constructive in ... announcing the remediation program, enhancing communications about the Next Generation Products approach and implementing changes to segment reporting in full-year results."

There are also situations where there is a need for interaction (or at least some form of asset management) and where the investor must take a position. These may include corporate actions such as a share issue where the investor can choose whether to

participate or not, or a proposed takeover (M&A) where the investor must decide whether to sell out or, if permitted, hold on to their shares. For most investors, some dialogue with the company will be necessary before any relevant conclusions can be drawn.

Most investors today regard voting rights as a form of client asset like any other asset they are managing on their behalf, and therefore something that should be considered carefully and exercised with due consideration. Voting takes place annually, at AGMs, and sometimes in between special meetings, known in most countries as extraordinary general meetings (EGMs). In addition to voting on reports and accounts, the issues considered at each AGM depend on local law, but are typically fundamental issues such as board structure, audit and oversight, executive compensation and the company's capital structure. Failure to consider such issues with due consideration could clearly be seen as a failure of fiduciary duty, and due consideration will often require active dialogue with the company to understand the issues and express any concerns and views.

Another incentive for investors to act as good stewards is the increasing expectations enshrined in laws, standards and regulations.

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!