



Proxy Voting and ESG Engagement With Different Asset Classes

ESG & Sustainability Transformation

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ESG Voting:

As mentioned earlier, shareholders have the right to vote at AGMs and EGMs, and in some markets, occasionally at other investor gatherings. In almost all cases, voting is proportionate to the percentage shareholding in the company and resolutions are usually passed when more than half of those voting support a vote. In a few cases, special resolutions require support by 75% of those voting, and there are unusual circumstances where the number of votes cast must exceed a threshold in terms of the overall share capital (and rarer still when the number of shareholders is important). Institutions typically vote for or against, although in many markets, there is also scope for a conscious abstention (for example, in the UK these votes are collated despite not legally being considered votes as such). This is considered an active decision rather than just an absence of a vote. Abstention can sometimes be a useful tool in an engagement process where the investor does not have a fixed view on an issue but certainly does not want to be in the potential position later of being hampered in its criticism of an action that it has in effect endorsed through its voting.

Given the public nature of company general meetings, where the results are announced publicly by the company and the events themselves are often open to the media, voting decisions are often the most visible element of stewardship and engagement. It thus gains disproportionate media attention, and major votes against earn significant media coverage. Fund managers are therefore often held to account, both in the public arena and by their clients, for individual voting decisions.

Voting is often referred to as “proxy voting” because the investor rarely physically attends the meeting where the voting occurs, but instead appoints an individual as proxy to cast the votes on their behalf (in most cases, this will be the chair of the company, although anyone physically at the meeting can be appointed). Votes vest in the legal owner of the shares, which may be the custodian or a unit trust vehicle or some other intermediary, meaning that even an institutional investor will usually need various formal paperwork in order to attend the meeting and to vote, not least that clearly identifying the individual who is physically representing the investor at the meeting.

With sizable portfolios of companies and AGMs usually occurring over compressed time periods (a few months in some markets, with the extreme being Japan where thousands of AGMs are held over just a few days), resourcing is a particular issue in the area of voting. Institutional investors typically lean on proxy firms to assist in processing votes and in providing advice on them. There are two dominant firms in this market:

- ISS, with around 80% of the market; and
- Glass Lewis, with the bulk of the remaining 20%; along with
- a few much smaller rivals, which have some market share, especially in a few localized markets.

The proxy advisers are often criticised by companies for taking what may appear to be narrow, inflexible approaches to voting and not facilitating the “explain” aspect of “comply/apply or explain.” But most investors would argue that the advisers’ role is to lack flexibility and to focus on the general guidance and that it must be up to investors to



display their closer understanding of individual companies and respond appropriately to explanations. The extent to which investors do indeed use their own judgment and avoid relying on their proxy advisers—particularly in often long tails of smaller holdings outside of their home market—is variable.

The vote is a key tool for the active investor, and any voting decision should be aligned with the investment thesis for the holding and any stewardship agenda that the institution has in relation to the company. Thus, for example,

- If there are concerns about the capital structure and financial viability of the business, investors need to pay close attention to votes in relation to dividends, share buybacks, share issuance, or scope for further debt burden.
- If there are concerns about the effectiveness or diversity of the board, that needs to be reflected in voting decisions on director re-elections (and particularly in relation to the members of the nominations committee).
- Worries about the independence or effectiveness of the audit process should be taken into account when voting on the reappointment of the auditor, its pay, and the reappointment of members of the audit committee.

Given the level of attention on executive pay, it is perhaps not surprising that investors take a close interest in resolutions on remuneration. In many markets there are both nonbinding annual resolutions to approve pay in the year and binding votes on forward-looking policies and any new pay schemes. These are in addition to votes on the appointment of the members of the remuneration committee.

Investors will also often reflect concerns about financial or sustainability reporting in their votes to approve the report and accounts. In most markets, this is a symbolic resolution, but the message sent by voting against it can still be significant. It is important to remember that even though most resolutions are seen as being purely G issues (e.g., the approval of the accounts and the dividend, the election of directors, related party transactions, appointment of the auditor, and capital structure decisions— share issuance and buyback authorities), there is no reason why investor decisions on such resolutions should be driven solely by G considerations.

This can be seen for example with the recent debate about the incorporation of climate change issues into the financial accounts (the financial statements in the back of the annual report, rather than the narrative reporting in the front half). In September 2020, investor groups representing more than US\$100 trillion in assets published an open letter calling for companies to follow International Accounting Standards Board (IASB) guidance and incorporate material climate change issues in their financials, fully disclosing their relevant assumptions. The investor groups also asked that auditors play their part in ensuring the delivery of this and indicated their preference that the assumptions used should be compatible with the goals of the Paris Agreement. A number of investors are considering how their voting might respond to any failures to live up to this call from investors. In particular, some are likely to vote against reports and accounts where it is not clear that climate change has been incorporated or that the assumptions are not disclosed. Some are considering voting against auditors of heavily climate-exposed companies that do not include climate issues among the key audit matters in their auditor reports. And others expect to vote against key board directors of companies that do not show sufficient signs of climate awareness where they have key risk exposures.

Any vote will rarely be meaningful in itself because there may be a range of reasons that an investor might have for voting in any particular way. Institutions therefore usually have active programs to communicate to companies why they have voted in particular ways,



either in writing or in dialogue. Many seek to have active discussions with companies as they work towards their voting decisions (helping them to tailor decisions to companies' particular circumstances) and use that as an opportunity to explain the thought process that lies behind any decision making. This dialogue is a form of low-level engagement, but it will only ever have limited impacts.

Even though institutional investors mostly do not physically attend shareholder meetings, perhaps stewards should give this opportunity more active consideration. Particularly at mid-sized and smaller companies, the attendance at AGMs can be small or negligible, and so an investor can gain unusually direct access to many directors at one time, with much scope for informal dialogue. Furthermore, because the full board typically attends most AGMs, these meetings can offer investors an unusual insight into board dynamics and the ease of relationships within the boardroom. Shareholder meetings usually offer opportunities for formal questioning of many board members (typically any committee chair will respond directly to questions, as well as the chair and executive directors; in some circumstances, the audit partner is in attendance too and may answer relevant questions—something that ought to increase if the recommendations of the Brydon Review are reflected in this respect), and this formal questioning can provide scope for both insight and influence. But many will find that the informal insights from actually participating in general meetings are of as much value.

ESG Engagement With Asset Classes:

Although most stewardship codes assert that they are intended to apply to all asset classes, their language and approach seem very much based in the world of public equity investment. This article will reflect that tendency to think first of public equity investment, but its application is much broader. That is because the codes (and this chapter) are written in terms of principles, which can be applied with good sense and intelligence across the full range of asset classes.

Many investment structures involve businesses investing in assets that in some ways look like public companies, with the immediate responsibility for managing direct property or infrastructure assets within their own boards and where directors and investors can engage. Private equity and other fund investment structures (including indirect property or infrastructure investments) will usually see the interface for investors being with the fund management organization rather than the underlying assets. However, the sense of accountability and the need for alignment arises just as much in these relationships as it does in any corporate governance structure.

The concepts of engagement need to be applied in a different way to respond to the circumstances and the levers of influence that are available. Because engagement is usually about influence rather than control, investors should have some scope for engagement success whichever formal structure they invest through.

Usually in these latter, more indirect, investment structures, the engagement issues are related to policies and approaches to ESG issues rather than specific individual asset concerns, but if a concern about an individual asset demonstrates that policy approaches may not be what the investor expects, then the engagement can be very specific indeed. An interesting case study of this has been the exclusion from private equity holdings of gun manufacturers and retailers by a number of asset owners, most notably CalSTRS (the Californian teachers' pension scheme, which was responding in particular to the number of shootings on US school premises). For example, Cerberus enabled its investors, including CalSTRS, to exit underlying holdings in retailer Remington Outdoor in 2015.

Although, in these cases, investors will not generally have a vote and do not have formal sanction on the parties, the sanction of selling a position or being unwilling to invest in



future opportunities remains. That is clearly a powerful sanction in most circumstances (especially if the asset owner is a large one) and is certainly enough for the investor's counterparty to pay attention to concerns that are raised.

Corporate Fixed Income Asset:

Fixed income investors may ultimately be concerned with the likelihood of default, but ESG factors can impact credit ratings and affect spreads, leading to short-term changes in value. Companies that regularly raise capital in fixed income markets are becoming more conscious of investors' interest in ESG as a material factor in their pricing of debt.

ESG engagement is also important to private debt, private equity, and property and infrastructure investments. These investments are often illiquid, relatively long term, and involve close partnership between the investor and investee. As a consequence, there is both motive and opportunity for ESG engagement.

In relation to fixed income, the PRI's guide *ESG Engagement for Fixed Income Investors: Managing Risks, Enhancing Returns* recommends that investors should prioritize engagement based on the following:

- The size of a holding in the portfolio;
- 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 push for conditions and disclosures around ESG is likely to be pre issuance. This can be difficult to implement in fast-moving public markets but is easier to effect in private debt issuance.

The investor's interaction with corporate debt issuers is most commonly with corporate treasury rather than more senior officials. In most cases, the parties are used to dialogue in relation to strategy, risk, financial structure (especially where the proposed debt sits in the debt hierarchy), and also, the covenants and protections for debt investors. Increasingly, however, dialogue about risk encompasses ESG matters, and debt investors are finding they can have some influence on the approach of fixed-income issuers.

This scope for influence is particularly clear where debt investors engage alongside equity investors (or where single investment firms bring together their engagement approaches in relation to investments in a single issuer regardless of the asset class exposure and the portfolio in which it is held). There are instances where equity and debt investors are direct rivals over issues; for example, in the case of some transactions or capital structurings or in the case of the company nearing insolvency. In almost all cases relating to ESG matters at companies that are going concerns, however, the interests of long-term investors (whether they are exposed to equity or debt) very much align, and it will benefit all if the corporation effectively deals with an ESG concern.

Sovereign Debt Asset:

The stewardship interaction with sovereign debt issuers is likely to be much more limited. Here, only the largest investors are likely to have any scope to influence the stance of nation states, and even then, the influence may be minimal. Therefore, the ESG approach usually applied in this asset class is screening or an ESG tilt in the investment process rather than engagement.



Having said that, there are early signs of steps to advance investor activity in this area, and the PRI has produced a guide for those seeking to engage with sovereign issuers. This guide makes clear the fledgling nature of engagement in this area and is focused on learning how engagement might happen rather than on highlighting successful case studies. There is a particular focus on educating sovereign issuers about the value of green bonds and the strong market appetite for such instruments.

The leading case study for sovereign debt engagement is the work by a group of 29 investors with assets of around US\$3.7 trillion to encourage the Brazilian government to do more to limit the destruction of the Amazon rainforest. Having also had contact through the Brazilian embassies in their home nations, the group wrote to the government in June 2020 noting among other things that “Brazilian sovereign bonds are also likely to be deemed high risk if deforestation continues”. At least some of the group are reported to be considering divesting existing holdings and excluding Brazilian debt from their sovereign portfolios to reflect these concerns. Sadly, it is unclear if this effort has had any positive influence, as other reports suggest that Amazon destruction accelerated through 2020, reaching a 12-year high.

Private Equity Asset:

Within private equity investments, direct ESG engagement will be undertaken by the general partner (GP, the private equity house) rather than the limited partner (LP, the asset owner), although individual LPs may wish to engage with their GPs on the ways in which they are monitoring and acting on ESG issues across their portfolios. As the PRI report ESG Monitoring, Reporting and Dialogue in Private Equity points out:

The process of portfolio monitoring has value protection and enhancement potential in itself, as a systematic approach for identifying material ESG issues, setting objectives and regularly tracking progress. It enables GPs: to identify anomalies and achievements; support regular engagement with the portfolio company on these issues; and strengthen company reporting practices that could have implications at exit.

Given that private equity provides a form of share ownership, the logic of extending the principles of the Stewardship Code to such investments may come more naturally. That’s especially true when the companies are early stage and the investor has a more substantial influence. The poor quality of the governance of a number of companies coming through the private equity system—for example, the very public failure of WeWork’s initial public offering was in significant part caused by poor corporate governance—suggests that often, less effective ESG is instilled in private equity companies than ought to be the case given the levers that private equity investors hold.

Infrastructure Asset:

Infrastructure investors are exposed to ESG across the economic lifetime of their assets. These exposures extend beyond issues related directly to a specific asset, such as health and safety, supply chains, and environment, to such factors as climate change, bribery and corruption, and the social license to operate. The PRI (2018a) recommends that investors consider eight potential mechanisms to act as engaged owners in infrastructure:

- Use ESG assessments undertaken during due diligence to prioritize attention to ESG considerations and potential for improving profitability, efficiency, and risk management.
- Include 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 with, and encourage, the management of the business to act on the identified ESG risks and opportunities using the mechanisms available.



- Define and communicate the expectations of ESG operations and maintenance performance to the infrastructure business managers.
- Ensure ESG factors identified as material during due diligence are explicitly woven into asset-level policies.
- Advocate a governance framework that clearly articulates who has responsibility for ESG and sustainability.
- Set performance targets for preserving or improving environmental and social impact, including regular reports to the board and investors.
- Where possible, make ESG information and expertise available to the asset or project company to help it develop capacity.

Like private equity and property, many investors in infrastructure will work through specialist managers. In these situations, the investor's responsibility is 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 for the PRI, AustralianSuper reported that one of their infrastructure managers had used detailed questionnaires based on the Global Reporting Initiative to analyze the impact of ESG issues for each of its 28 existing assets. This analysis and benchmarking across the assets enabled the fund manager to:

- Improve the governance at each of the boards on which it sits;
- Arrange for four Australian airports to work together to develop market best practice health and safety processes based on practices from each of the airports; and
- Measure the electricity and water usage and carbon emissions of each its assets on a regular basis, enabling the identification of energy savings for many assets.

Property Asset:

As with fixed income, there is good evidence of the positive effect of ESG on returns to real estate investments. Friede, Busch and Bassen's 2015 study determined that 57% of equity studies showed a positive effect, although the positive share for bond studies was 64%, rising to 71% for real estate.

A 2014 INREV study indicated that there was a 2.8% difference in return spread between the top 10% and the bottom 10% of Global Real Estate Sustainability Benchmark (GRESB) rated properties. Regulatory changes are also driving a need for greater engagement in relation to ESG in real estate.

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

- Engage, directly or indirectly, on public policy to manage risks;
- Support research on ESG and climate risks; and
- Support sector initiatives to develop resources to understand risks and integrate ESG.

Fund Investments Asset:

For funds of funds as an asset class, engagement with fund vehicles, covering any underlying asset class, sometimes becomes a little more complex. However, there is typically a fund board, which should be there to represent investor interests and that can be subject to engagement. Investors are often distanced from the underlying assets, but the role is then to hold to account the managers of the fund for their own investment and



stewardship efforts. Closing the agency gap in these sorts of vehicles can be harder and take more effort, but as long as the investor has this in mind, there is certainly a role for engagement to play.

To learn more about ESG and sustainability-related models, don't hesitate to contact [**YTT Consulting!**](mailto:info@ytt-consulting.com)

