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Is Engagement More Powerful Than Exclusion?

The focus on sustainability across the investment industry and around the corporate world has intensified significantly in recent years. This is especially true for investors.

We believe that short term–oriented corporate behaviour, driven partly by short term–focused investors, is creating, or at least exacerbating, social and environmental stresses that threaten to undermine the very system in which they operate.

So how best can MFS,® in its capacity as an investor in public markets and acting on behalf of investors, play a part in managing sustainability-related risks?

Is exclusion the answer?

It could be argued that building a portfolio comprising only 'good' companies with strong ESG credentials and excluding everything else is not a bad way to generate investment returns. It seems logical to us that companies addressing real social and environmental needs should, all else being equal, have better long-term prospects than companies causing harm to either people or planet.

But all else does need to be equal. For example, ask yourself these questions:

1 What if a company 'doing good' is unable to deliver durable profit growth because it has no enduring competitive advantage?

2 Even if a company does have a lasting competitive advantage, what if your entry point is at such a high valuation that returns are likely to be disappointing?

In these cases, we believe exclusion is unlikely to prove an effective investment approach. We view exclusion in this context as an abdication of responsibility, not the exercise of it. That's because in public markets, excluding companies passes the issues on to other investors rather than seeking to positively influence the companies we are invested in.

Engagement as a force for change

What can sustainability-minded investors do? We believe they should engage as proactive stewards of capital and use the power of the capital markets as the point of leverage on which we can effect change in the real economy

We need to know our limits — we should not presume to understand our companies better than the people managing them. However, as long-term investors, we should make it clear where our priorities lie:

- We would like companies to be managed for long-term value creation, not short-term profit maximisation.
- We think that good management teams will generally pay due care and attention to social and environmental externalities that could lead to a material financial cost at some point down the line.
- If engagement bears no fruit, we will exercise our voting powers to force the issue.

Engagement and proxy voting are meant to work in tandem. Proxy votes, unlike engagement alone, can provide a measurable snapshot of investor sentiment and can force the adoption of binding resolutions on companies not cooperating with investors.

Whilst many activist investors are aggressive in their engagement strategies, the rise of collective engagement organisations has been driven by some of the largest asset managers and asset owners. Taking part in collective engagement gives both larger and smaller shareholders a powerful voice for communicating and a forum for influencing change.

We believe working together allows for a more efficient engagement process and encourages productive discussions on the issues at hand. Overall, in our view, collective engagement can lead to more effective, reasonable engagements that have the power to drive change in the real economy.

Aligning with clients on value creation

Most investors share a common goal: to seek to generate strong, durable risk-adjusted returns. It is our obligation and fiduciary duty as investment managers to behave as long-term owners when we invest our clients' assets.

To us, exclusionary policies limit our effectiveness and do not help us achieve this goal for our clients. We believe thoughtful engagement and proxy voting practices are vital to encouraging long-term value creation and economic growth.

Key questions for asset owners to ask their investment managers

- How do you approach sustainability?
- Is it part of your investment process or a separate product?
- How do you determine whether an issue is material or not?
- Do you exclude any companies or industries based on sustainability concerns?
- Which members of your investment team have responsibility for looking at ESG factors?
- Do you engage with companies to understand how they view ESG risks and opportunities?
- Do you vote proxies in-house or do you outsource proxy voting responsibility?
- What reporting and metrics do you provide to evidence your stewardship activities?

To learn more about how sustainable investing works at MFS, please visit our latest Sustainable Investing Annual Report.

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