Engagement: An Important Tool for All Investors

In brief:

- Investor engagement is under the spotlight, and rightly so. It is a powerful tool for all long-term investors that we believe the investment industry as a whole has underutilized.
- Both passive and active managers have an important role to play in realizing the potential value that engagement can add.
- While large passive managers have the size to influence voting on broad issues, their scale hinders their ability to effect nuanced engagements with companies.
- Conversely, as active management is more fragmented, active investors with deep research capabilities are able to perform “materiality discovery” (similar to price discovery) and proactively engage with investee companies to instigate change.
- We believe that all investors should evaluate their engagement practices to ensure they are maximizing their ability to improve long-term outcomes for all stakeholders.

Active ownership practices, such as issuer engagement and proxy voting, can have a positive long-term impact on the governance and business practices of corporate issuers.

While a number of managers count themselves among those who act with conviction on this matter, we believe that the broader investment community has not yet realized the full potential of active ownership in the interest of creating long-term value for their clients. We therefore encourage an open dialogue on the importance of active ownership and how all investors can be better owners and stewards of capital.

We must acknowledge, at the outset, that for practical purposes this discussion only pertains to long-term investors. Short-term investors, whether or not they consider ESG (environmental, social and governance) risks and opportunities within the context of their trading strategies, have little to gain from active ownership practices as these activities are generally not expected to impact prices in the short term.

By the same token, we believe investors with longer time horizons have much to gain from regular and proactive engagement on ESG topics as these issues inevitably impact security valuations over the long term. Engaging and communicating regularly with portfolio companies on relevant ESG issues is a powerful tool that supports value preservation and sustainable long-term growth.

With institutional ownership representing 80% of the listed equity market, we can argue that the asset managers charged with stewarding that capital bear a responsibility to improve the long-term sustainability of the companies in which they invest. Viewed in this way, the engagement objectives of active and passive managers are similar: to increase the financial value of the companies they own and to improve overall outcomes for all stakeholders.
The role that passive managers can play

Despite their inability to reallocate capital at will, passive managers are still incentivized to engage with a long-term mindset. Since many major indices have historically exhibited relatively low turnover, indexers are often de facto long-term owners. In addition, there is growing reputational and regulatory pressure for leading passive managers to take on a more proactive monitoring role.2

Passive managers have begun to allocate meaningful resources to their stewardship efforts; however, the sheer number of companies they hold (over 10,000, in some cases) can still present a challenge to conducting thoughtful engagements. As such, while fundamental active managers can, and should, be intimately familiar with each company and able to precisely tailor engagements based on what they deem most material, passive managers may be forced to focus on a more limited and standardized range of issues.

The diligent exercise of proxy voting rights, similar to engagement, is a critical component of active ownership. Although asset managers wield tremendous power over the outcome of ballot proposals, brought to a vote either by management or by shareholders, that power has largely lain dormant.

While forced ownership can undermine passive managers’ influence over company management teams, the outsized proportion of assets governed by a few large passive managers provides each of them considerable voting power. Three of the largest passive managers combined — BlackRock, Vanguard and State Street — control a majority of shares of many S&P 500 companies.3

This sort of concentration of corporate ownership speaks to the significant influence that a relatively small number of managers can have on major corporate decisions. Given the historical tendency for some passive managers, in certain cases, to routinely vote in line with management recommendations on shareholder proposals that consider potentially material ESG risks, some shareholders might question whether these managers should be more critical of management.

For example, in 2017, two of the three largest passive managers voted in favor of less than 15% of climate-related 2-Degree Scenario shareholder proposals. These proposals have typically called for enhanced measurement and disclosure of individual companies’ climate change impacts. To demonstrate the potential power the passive managers have, consider that at least eight of the 14 key 2-Degree Scenario proposals filed in 2017 would have passed if just one of the three largest passive shareholders had supported them.4

How active managers can use ESG engagement for long-term value creation

Capital markets rely on active investors to price and allocate capital efficiently. In the same way, we believe markets will increasingly rely on active investors to indicate the materiality of the ESG issues that investee companies are facing.

Active managers with a long-term investment horizon are well aligned to benefit from engagement and ESG integration. Our belief is that engaging with portfolio companies on both financial and non-financial issues can help active managers make better investment decisions. Engagement has also often positively influenced governance and business practices by demonstrating to executive teams that these issues are important to their investor base and potentially material to the long-term
sustainability of their businesses. In our experience, engagement activity has resulted in meaningful changes to many important areas of focus such as increased adoption of governance provisions like majority voting and proxy access, increased disclosures around environmental impact, diversity and political contributions and efforts to shift executive compensation plans toward longer-term incentives. We have also noted an increase in companies linking long-term incentives to climate change-related metrics, as well as enhanced disclosure around sustainability efforts.

One specific example relates to positive changes to the compensation structure at a US-based pharmaceutical company. Collaboration between our proxy voting team and investment team raised concerns that certain metrics underpinning the company’s short-term executive incentive plan could potentially result in an excessive pay package. Over the course of multiple engagement calls, we communicated our concerns and discussed the specific components of the plan that were potentially problematic. In response to such shareholder feedback, the company has made meaningful revisions to their incentive structure.

Where next for investors?

Investment decisions and proxy votes are an outcome of the resources put into research and engagement. According to a survey conducted by the Principles for Responsible Investment (PRI), one of the top barriers to engagement success, from the corporate perspective, is a lack of investor preparation and detailed knowledge about the company. In our experience, a strong collaboration between investment teams and stewardship teams is essential to achieving engagement objectives. Additionally, proxy votes, unlike engagement alone, yield a measurable snapshot of investor sentiment. It is therefore crucial that asset managers consider:

- Communicating their stances through votes in addition to engagement
- Voting in line with an appropriate set of standards and policies, and not hesitating to vote against management
- Maintaining an open dialogue with issuers in the interest of communicating the rationale behind policies and votes both leading up to and following shareholder meetings
- Encouraging collaboration between stewardship teams and investment professionals so that voting decisions are well informed and truly in the best long-term interest of shareholders

The majority of investors have a similar goal — to generate strong, sustainable 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. Thoughtful engagement and proxy voting practices are vital to encouraging sustainable value creation and economic growth.

While active and passive management styles are quite different, all investors can exercise active ownership practices in the interest of long-term value creation. As we look for the continued development and improvement of ESG and oversight practices by the companies we invest in, we must continue to be active in our corporate engagement outreach and have well-informed discussions on the issues that matter most.
Endnotes

1 Pension & Investments (2017).


