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Engaging effectively

New insights into the effectiveness of shareholder engagement strategies

Summary of a workshop hosted by the Mistra Sustainable Investments Platform on 26 August 2010

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onValues Ltd.
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"Disengaged investors lead to ownerless corporations and the risk of unaccountable executives and boards running amok. It carries with it substantial economic risk."

— Lord Paul Myners *(NAPF Investment Conference 2009)*

Background

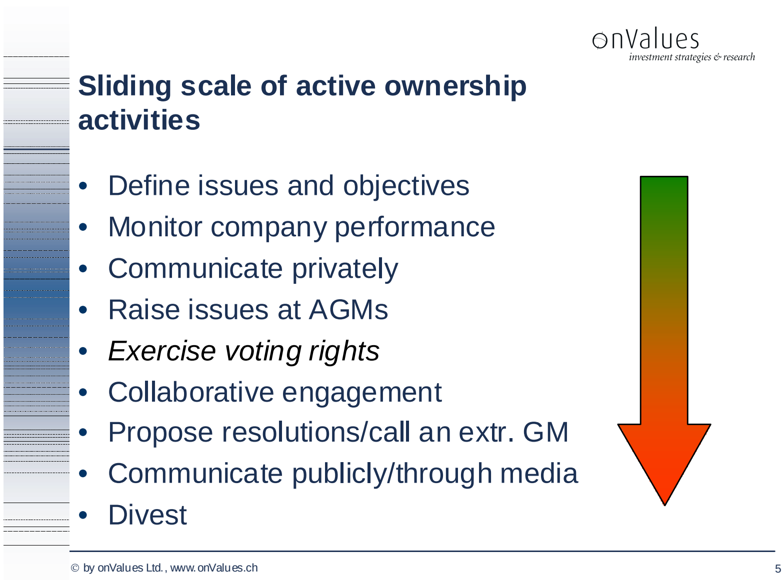
Institutional investors are increasingly becoming active owners through voting their shares and engaging in dialogue with companies. This Mistra workshop was an opportunity to review the state-of-the-art of shareholder engagement and of the approaches and techniques that have been used by investors in the past years, in view of further improving their effectiveness.

For the purpose of the workshop, effectiveness was defined as the degree to which investor engagement leads to desired improvements in the environmental, social and governance (ESG) performance of companies. Investor motives for engaging (e.g. enhancing investment returns, contributing to sustainable development, or a combination of the two) were not the subject of the workshop.

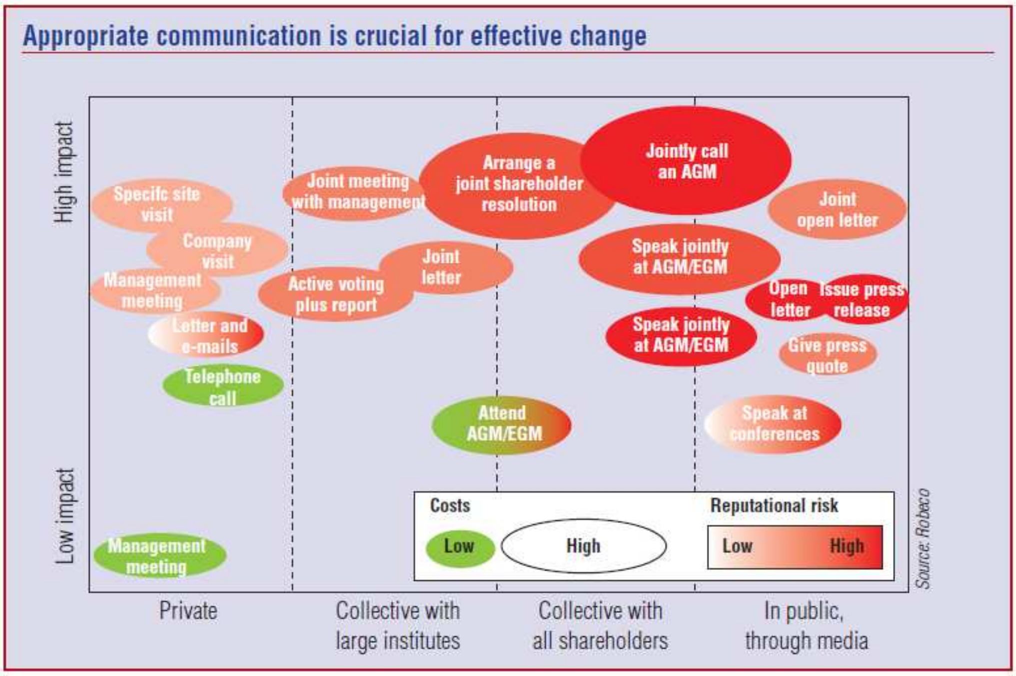
The key questions addressed during the workshop included the following:
- What are the key factors that contribute to effective engagement?
- What can be said about the effectiveness of different forms of 'delegated' engagement (e.g. delegation to service providers, to collaborative initiatives, to asset managers)?
- How can different engagement approaches be combined to maximise effectiveness ('portfolio approach')?
- What can a small asset owner with limited resources do to maximise its impact?

Shareholder engagement is part of the wider concept of active ownership. There is a sliding scale of active ownership activities open to equity (and possibly other) investors (see the figure below):

- The scale begins with the asset stewardship concept and the obligation to monitor all issues that may contribute to the performance of the investment
- Increasing levels of activity are often accompanied by increasing confrontation with management and potentially an increasingly public forum for the activities
- More public forms of active ownership (e.g. proposing shareholder resolutions) are often seen as a 'fall-back' only when private options have not been successful.



Choosing the right tone and the appropriate communication means at the right moment in the engagement process is crucial for success. The more public forms of engagement can be very effective but also entail the largest risks, including reputation risks for both target companies and investors (see the figure below).



Source: Eric Breen, Robeco, Responsible Investor, Nov. 2008

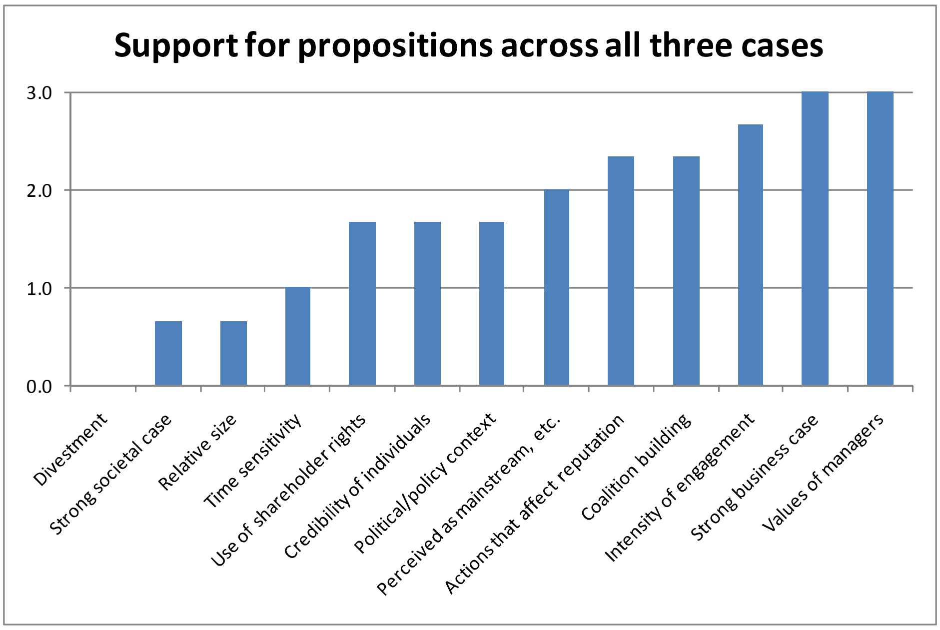
Selected insights from the workshop

In the following sections we present a summary of the key points made during the workshop's plenary and break-out sessions. The workshop was conducted under the Chatham House Rule, and as such the points are not attributed to individual participants.

Factors contributing to effective engagement

In their introductory presentations, James Gifford and Ian Hamilton presented two frameworks that explain the importance of different factors determining the influence of investors on companies. Gifford's framework includes four main categories: power-, legitimacy-, urgency-related factors, and moderating influences.

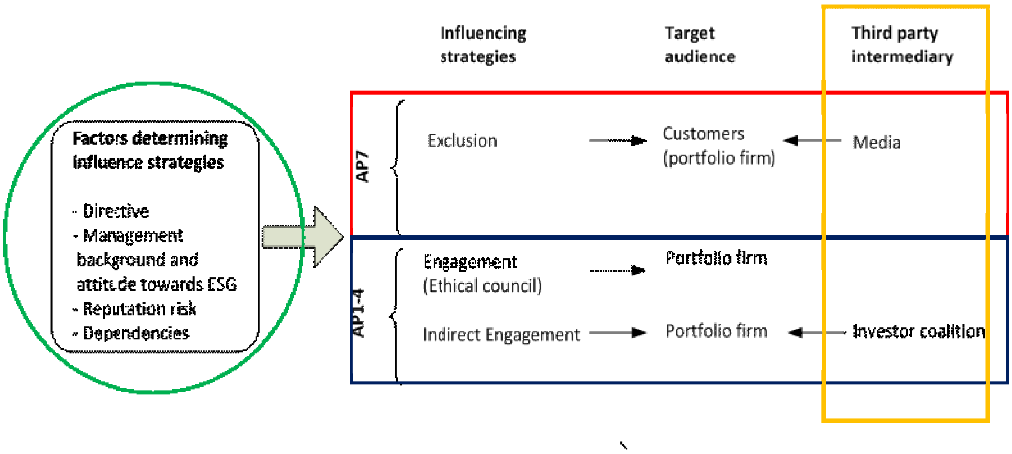
Based on extensive analysis of real cases, Gifford ranked the relative importance of different factors for determining shareholder salience (see the next figure). In his presentation Gifford explicitly mentioned that according to his research size is less important than often assumed. A large investor engaging a small company is not necessarily more successful than a smaller investor engaging a larger company. Gifford also stressed the importance of targeting engagement activities to companies where management values are at least partly 'in tune' with the goals of the engagement. He also noted that the personal reputations of the CEO and of the chairman of target companies were important points of leverage for a successful engagement.



Source: E. James M. Gifford, 'Effective shareholder engagement: the factors that contribute to shareholder salience', PhD Thesis, 2010

In his research, Ian Hamilton assessed the factors determining the influence strategy of the Swedish AP7 fund versus the strategy chosen by the AP1 to AP4 funds (next figure).

AP fund influence strategies, target audience and external support:



Source: Ian Hamilton, Jessica Eriksson: 'Influence strategies in shareholder engagement: A case study of five Swedish national pension funds', Umea School of Business, 2010

The discussion that followed the presentations confirmed the usefulness of the two frameworks, but also added additional insights based on participants' practical experience:

- Several participants stressed that focussing on issues that are expected to have a significant financial impact on companies (with a clear business case) greatly enhances the effectiveness of the engagement. For ESG issues the business case often materialises over longer time-horizons, a fact that needs to be well explained to companies.
- In the presence of market failures, investors will need to direct their engagement activities to the public policy and regulatory level (given the absence of a business case at the company level)
- There was general agreement that you don't necessarily have to be a shareholder to successfully engage with a company. Also fixed-income, private equity, property investors etc. can effectively engage with issuers.
- Generally, engagement activities 'closer to home' are more effective. Clearly, understanding the cultural context in which institutions operate is key to successful engagement. A growing number of pension funds are therefore collaborating with other funds that each engage in their local markets on behalf of the whole group. As participants noted, this approach often doesn't work in Japan or in emerging markets where it is difficult to find active institutional owners willing to collaborate with foreign investors.
- When collaborating with other investors, it was stressed that keeping the group small at the beginning (e.g. 5-6 pension funds take the lead in launching an activity through the PRI Clearinghouse, others follow) is an important way of keeping the engagement process efficient
- Participants agreed that for certain types of issues and stages in the engagement process it makes sense to 'go public' and involve the media. The media is a strong, albeit volatile amplifier of messages. Involving the media automatically triggers high reputation risks for both investors and companies involved. Company management will consider this a very confrontative approach and shut the door to future dialogues. Investors that are interested in a long-term approach to engagement should therefore involve the media only as a last resort. Two participants reported positive experiences in collaborating with the media, but stressed the importance of involving the media at an early stage and supplying it with contextual information to understand what engagement is about.
- Several participants stressed the fact that successful engagement activities can take a long time and that therefore persistence is a key success factor
- A participant from the academic world questioned the feasibility of assessing the effectiveness of engagement activities, be it in relation to enhancing long-term investment returns, reducing risk levels or contributing to sustainable development. But the majority of participants were of the opinion that through a range of indicators it was today possible to qualitatively assess effectiveness.
- Some participants pointed to Mistra having an intrinsic authority on environmental issues (given its proximity to academic research and its reputation in the field) and this being conducive to a successful engagement activity in spite of the relatively small size of Mistra's assets.

Delegating and pooling engagement

In the past years, investors' possibilities to delegate and pool engagement activities by using collaborative initiatives or professional service providers, has been greatly enhanced. Two representatives of engagement service providers (Colin Melvin, Hermes EOS, and Hanna Roberts, GES Investment Services) and two representatives of collaborative investor initiatives (Allan Emanuelsson, Sustainable Value Creation Initiative, and Amanda Haworth Wiklund, Carbon Disclosure Project) presented their experience in the course of a panel discussion that was subsequently opened to all participants. Key insights from the discussion include:

- Pooling engagement activities was seen as the single most important approach to enhancing effectiveness
- There can be several layers of pooling, as exemplified by the example of the AP1-4 funds that pool some of their activities in the Ethical Council, which in turn delegates certain activities to service providers or participates in collaborative initiatives, thus further pooling engagement
- A majority of participants agreed that delegating and pooling engagement (even if done multiple times), does not diminish its effectiveness as long as the power, legitimacy and urgency characteristics of the institution carrying out the engagement are strong
- The other side of the medal is that multiple layers of delegation and pooling lead to a loss of control of investors on the ultimate engagement activity, diluting the concept of 'shareholder democracy' (the freedom of beneficiaries to define the issues relevant to them), as several participants highlighted
- It was noted that collaborations between investors are especially valuable at the stage of researching ESG issues and defining engagement strategies (the most resource intensive part of the engagement process), whereas implementing the engagement activity can more easily be done single-handedly
- A participant mentioned that investment consultants, especially in the context of fiduciary management solutions, could in future play an important role in pooling investor influence and improving the effectiveness of engagement activities
- There was general agreement that industry-wide or policy-related issues are best tackled through broad collaborative initiatives. As exemplified by the Sustainable Value Creation and the CDP initiatives, issues relating to improving transparency and disclosure also belong to this category. One participant warned that the disadvantage of such broad initiatives is their slowness.
- It was noted that potential regulations to limit investors 'acting in concert' or accessing private information represent a serious risk to the further expansion of pooled engagements (the EU Green Paper on this subject was specifically mentioned). One participant mentioned policy makers' latent concern about a 'privatisation of regulation' implied by an excessive influence of institutional investors on the way the economy is run
- In principle, delegating engagement activities to external asset managers operating on behalf of an asset owner makes a lot of sense (investment managers know their companies well, meet them regularly and can pool the influence of multiple investors, all characteristics that are conducive to effective engagement). But in practice, as noted by participants, asset managers often don't have the detailed ESG know-how, the right incentives and the time needed to engage effectively.
- Some of the engagement service providers present at the meeting mentioned that they also support asset managers in engaging more effectively on behalf of their clients or that they jointly engage with asset managers (e.g. meeting the management of companies jointly).

Combining engagement approaches, using synergies, maximising impact given limited resources

In the course of parallel break-out group discussions, all participants shared their practical experience in combining different engagement activities, using synergies among them and maximising engagement effectiveness considering limited time and resources available.

The most important lessons-learned from the discussions include:

- There was general agreement in the room that investors, service providers and collaborative initiatives are already coordinating their engagement activities fairly well, but that there is still room to use synergies better.
- Given limited resources, investors will inevitably have to limit the scope of their engagement to a small number of priority issues and targets. Through the pooling of engagement activities with other investors, the scope can be considerably enlarged. Some investors consciously invest a growing part of their assets in the form of concentrated portfolios, in view of having a better understanding and access to the management of portfolio companies.
- Other participants mentioned their strict ESG selection criteria for investments ('high ESG quality' portfolios) leading to ESG engagement being needed less
- Participants noted that collaborative initiatives focussing on better company disclosure can substantially improve the efficiency of other engagement activities (e.g. based on improved disclosure in response to the SVC and CDP initiatives, investors are able to better triage engagement targets). It is therefore worthwhile allocating time and resources to such initiatives. These initiatives also counteract widespread 'questionnaire fatigue' by companies.
- Participants conceded that for small asset owners it is challenging to define and manage engagement activities given the resources and time needed. This probably explains why smaller foundations, family offices and many religious investors are so conspicuously absent from the engagement world. It was mentioned that joint platforms (similar to AP1-4's Ethical Council) could be a way forward for small asset owners to pool their influence and resources.
- It was noted that the UN Principles for Responsible Investment initiative has launched a working group that is specifically looking at the challenges faced by small asset owners with limited resources. Engagement service providers at the workshop mentioned that their services were priced in a way to make them accessible also to smaller owners.

Strengthening the links with academia

A key component of the Mistra Sustainable Investments Platform workshops is the exchange of information between academics and investment practitioners and the generation of ideas for future academic research. The workshop discussions identified several areas in which further academic research on the effectiveness of investor engagement with companies would be useful.

One such area revolves around defining and measuring the effectiveness of engagement activities. A more in-depth understanding of the factors determining the influence of investors on companies is another area where further research is needed.

Ian Hamilton, in his presentation, also indicated additional areas for further research:

- Effective shareholder engagement from portfolio companies' perspective
- Beneficiaries' attitude about ESG integration in investment practice.

Appendices

About the host

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Mistra, the Foundation for Strategic Environmental Research, aims to make a difference in the field of sustainable development. The Foundation achieves this by funding groups in the academic community that contribute to solving major environmental problems through applied research. Each year Mistra invests approximately SEK 200 million in the research programmes it supports.

The entirety of Mistra's endowment, which is valued at approximately SEK 2.8 billion, is invested using external asset managers that explicitly take account of environmental, social and governance issues.

Event conceptualisation and facilitation

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Agenda

12:00 Networking lunch

13:00 Welcome; framing the issues

- Lars-Erik Liljelund, Fredrik Gunnarsson, Mistra
- Ivo Knoepfel, onValues

13:15 Discussion 1: Factors contributing to effective shareholder engagement

- James Gifford, UN Principles for Responsible Investment
- Ian Hamilton, Umea University

- Discussion to address:
  - ➔ What are the key factors that contribute to shareholder salience in improving the ESG performance of investee companies?
  - ➔ How do cultural and regulatory environments influence approaches to engagement?
  - ➔ Managing reputation risks: the role of the media and other stakeholders in influencing engagement choices
  - ➔ Can the effectiveness of shareholder engagement be measured?

14:10 Coffee break

14:30 Discussion 2: Choosing the right implementation "mix": direct engagement vs. using external service providers vs. joining collaborative investor initiatives

Discussion with:
- Allan Emanuelsson, DnBNOR/Sustainable Value Creation
- Amanda Haworth Wiklund, Carbon Disclosure Project
- Colin Melvin, Hermes Equity Ownership Services
- Hanna Roberts, GES Investment Services

..and contributions from all participants

15:30 Parallel break-out groups (two groups)

Discussion to address:
- Experience of all workshop participants in terms of what works best
- When does it make sense to pool engagement via specialist firms?
- When are industry-wide engagement initiatives needed? What are their advantages?
- Are regulations relating to 'acting in concert' impeding more collaboration among pension funds?
- What is the best approach to assessing and reporting the effectiveness of engagement programmes, what can we learn from the GES and Hermes examples?
- What can we learn from CDP and SVC in terms of designing successful initiatives? Can their effectiveness be assessed?

16:30 Closing plenary discussion

- Main findings from the break-out sessions are shared in the plenary
- Lessons-learned in terms of developing a 'portfolio approach' to engagement
  - ➔ When does it make sense to do it alone, to outsource to specialists, to coordinate efforts in a small group of like-minded investors, to support industry-wide engagement initiatives?
- Closing remarks, Ivo Knoepfel

17:15 Adjourn

Participants

Organisation	FirstName	LastName	Country
AP1	Nadine	Viel Lamare	Sweden
AP2	Christina	Olivecrona	Sweden
BankInvest Group	Katja	Karas	Denmark
Carbon Disclosure Project	Amanda	Haworth Wiklund	Sweden
DnB NOR Asset Management	Pär	Löfving	Sweden
DnB NOR Asset Management	Allan	Emanuelsson	Sweden
Ethical Council of Sweden's AP Funds	John	Howchin	Sweden
Ethix SRI Advisors	Ulrika	Hasselgren	Sweden
F&C Asset Management	Karina A	Litvack	UK
Generation Investment Management	Esther	Gilmore	UK
GES Investment Services	Hanna	Roberts	Sweden
Hermes EOS	Colin	Melvin	UK
IPM Informed Portfolio Management	Anna	Gorka	Sweden
Mercer (UK)	Susanna	Jacobson	Denmark
Mistra	Lars-Erik	Liljelund	Sweden
Mistra	Fredrik	Gunnarsson	Sweden
Nordea	Sasja	Beslik	Sweden
onValues	Ivo H	Knoepfel	Switzerland
Svenska kyrkan	Gunnela	Hahn	Sweden
Svenska kyrkan	Anders	Thorendal	Sweden
Swedbank Robur	Anna	Nilsson	Sweden
Umeå University	Elisabeth	Nore	Sweden
Umeå University	Lars G	Hassel	Sweden
Umeå University	Ian	Hamilton	Sweden
UN Principles for Responsible Investment	James	Gifford	UK
University of Gothenburg	Joakim	Sandberg	Sweden
	Ingrid	Jansson	Sweden
	Måns	Lönnroth	Sweden