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ESG and Coordinated Engagements: A Conversation with The Brandes Institute "Call for Papers Contest" Winners

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Introduction

Winners in the Brandes Institute's "Call for Papers" contest joined members of the Brandes Institute's Advisory Board for a virtual roundtable discussion of their prize-winning paper, "Coordinated Engagements." Attendees could share comments and questions via audio/video connection or a "chat" feature available in the call-in platform.

THE WINNERS:

DR. ELROY DIMSON
Research Director and Chairman of the Centre for Endowment Asset Management at the University of Cambridge Judge Business School

DR. OĞUZHAN KARAKAŞ
Co-Director of the Centre for Endowment Asset Management at the University of Cambridge Judge Business School

DR. XI LI
Associate Professor of Accounting at London School of Economics and Research Fellow at the Centre for Endowment Asset Management at the University of Cambridge Judge Business School

The three co-authors edged 60 other entries from universities worldwide to split a US$15,000 award. To read and/or download their complete report, visit this link.

Dr. Elroy Dimson summarized the trio's findings by posing a series of questions and then opened the discussion to broader questions from attendees.

"When we look at the outcomes, where the engagement achieved its E and S objectives, we find that is followed by higher abnormal, market-factor-adjusted returns, higher return on assets and higher sales growth."
– Dr. Elroy Dimson

Dimson: We studied groups of investors working together to engage with the companies they own. This is the first paper to look at the nature and benefits of working in a coordinated, collaborative and international way to make a difference on environmental and social [E&S] issues.

The data we use has come through extensive collaborations with the United Nations-Supported Principles for Responsible Investing [PRI]. PRI includes more than 3800 signatory organizations—mostly investment managers and asset owners (AO)—from 60 different countries and more than $120 trillion in assets.

WHAT'S THE IMPACT OF SUCCESSFUL ENGAGEMENT?

We looked at successful engagements with the benefit of a lead investor. When we look at the outcomes, where the engagement achieved its E and S objectives, we find that is followed by higher abnormal, market-factor-adjusted returns, higher return on assets and higher sales growth.

We also find those firms turn out to have lower volatility compared to otherwise similar companies. We find there's no change in the lead activist shareholdings—and that's consistent with investors who think they are holding for the long run.

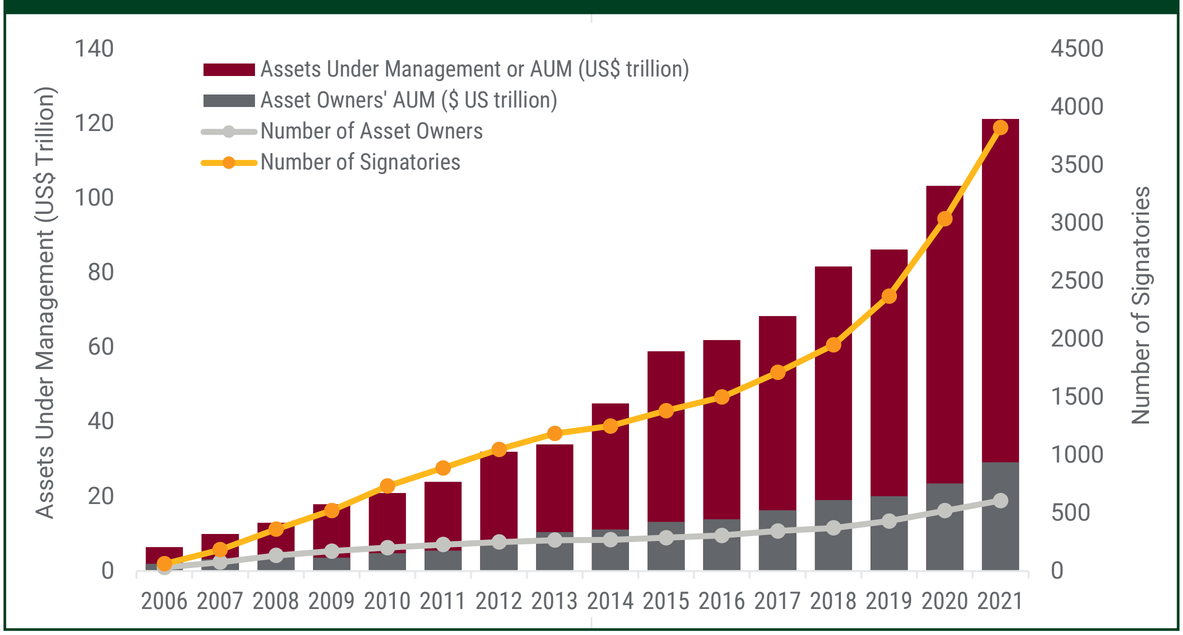
Supporting activists tend to decrease their holdings after the action is out of the way and after the behavior has changed for the better but, also after on average, the stock price has gone up.

WHAT IS PRI'S COLLABORATIVE PLATFORM AND WHAT ABOUT THE DATA IT'S COLLECTED?

There are a series of collaborations that signatories can sign up for and PRI helps coordinate them. There are four, key features of the data PRI has collected:

1. Engagements are logged by a third party, so there are no retrospective data revisions.
2. Engagements are supported by multiple asset owners, investment managers and service providers—not a single firm.
3. The data set is global; and
4. Each engagement is dated.

GROWTH IN PRI SIGNATORIES AND ASSETS



Source: Principles for Responsible Investment Report 2021. AUM based on active signatories as of 4/30/2021.

We have comprehensive data from 2007 to 2017. PRI uses use the term *dialogue*, which means a continued conversation. It's not how you vote on a proposal, for example. It's much broader. We have 1,654 dialogues with target companies. The companies are 960 listed firms in 63 countries.

WHAT ARE THE BENEFITS OF COLLABORATION?

Players can pool resources. They have more voting power. They can share the risks and information and costs. There are legal concerns of creating a concert party which is frowned upon in some jurisdictions. PRI can help overcome that.

WHAT WERE OUR FINDINGS?

Most targeted firms were in the United States, the United Kingdom, France and Japan. Most targeted industries: manufacturing; infrastructure and utilities; wholesale/retail.

Target firm traits: large companies with a high percentage of sales from abroad; high ownership from the engaging group; and this may come as a surprise, but the target companies tend to have a high ESG score. We saw companies that have some commitment to doing the right thing.

WHICH INSTITUTIONS ENGAGE AND LEAD?

Average engagement has 26 signatories: two domestic investors and 24 foreign investors. That 26 consists of 14 asset managers, 11 asset owners and 1 service provider.

We see an inverse, U-shaped relationship between signatory size and engagements. Tiny companies are not only overlooked in terms of engagement with them, but asset owners that are really tiny have little time to spare on engagement. The huge firms such as State Street and Blackrock don't get involved with PRI activity. They tend to do things on their own.

Those engaging tend to have a 2-tier strategy. They have one or occasionally more than one signatory that leads and other signatories who support. All together, we have 393 engagements out of 1,654 that have a lead investor and we look at the influence of that leadership.

WHAT ARE DETERMINERS OF SUCCESS?

Success is measured by metrics that PRI pursued. There will be an objective to achieve an end result, but for all of these, the extent to which there is success in changing the way the company behaves is not a decision made with hindsight by the investor companies. It's PRI who appraises the success of these engagements.

If there are influential investors – large level of assets overall, a big holding in the target company and a formal process for dealing with engagement—those are the ones associated with more successful engagements.

Q&A SESSION

Q: Are there limitations and/or legal issues of engaging with other investors on these ESG issues?

Karakaş: Countries differ in their regulations in the way coordinations are allowed, encouraged or discouraged. There is a wonderful paper we cite in our work called "Hail Britannia!" by law scholars Black and Coffee. For various reasons, the US has evolved in a way vs. the UK that discourages such institutions to collaborate.

Secondly, the PRI has six principles for responsible investing. I understand that even in the United States, if organizations act on agreed principles, then it is not necessarily considered as acting in concert with others.

Q: Can smaller boutique managers change corporate behavior?

Li: No matter how small you are, you should join a coordinated engagement because, relative to engaging by yourself, this is a cheaper approach. And you have a third party, PRI, trying to coordinate and spread out resources, so you don't have an additional cost to join.

In recent years, PRI has increased its requirement for signatories in terms of what they mean by "active." So even if you are small, they require you to be active. PRI doesn't want free riders—companies who just join the engagements and do nothing. So, even if you're a small firm, you should join and spend whatever resources you have in trying to help.

We also find that the investor group's aggregate ownership in the target firm makes a difference. So, if you can contribute, this is going to be a plus for the success of the engagement.

Kim Shannon: I understand exactly what you're talking about. As a small asset manager, we feel pressure on all sides: our desire to do good governance and oversight, our clients' expectations, prospective clients' expectations, consultants who rank our efforts, and the UNPRI's reporting and ranking requirements. We're expected to regularly report engagements to all our stakeholders, so we report both the direct engagements we do with our investment holding companies as well as the collective engagements for our portfolio holdings from our membership in the Canadian Coalition for Good Governance (CCGG). We follow up and track the improvements in activity and reporting by the investments over time as they get implemented.

Dimson: For a long period, I was involved in the investment committee for a small- to medium-sized charity. They asked if they should sign up to PRI. Some of the programs are helpful from an educational perspective and the networking opportunities to meet with others, so I looked up what it would cost. I repeated that exercise last night. If you've got under 100 million pounds in assets, the fee is 478 pounds or about US$500. It's remarkably little. It is a way of making a clear commitment in this area. It is among the least expensive commitments you can make toward corporate and individual good.

Barclay Douglas: What about asset managers that run money passively vs. actively? Do you find that there are differences in the projects or causes and their passion on the project and their success rate?

Dimson: The very biggest asset managers—Blackrock, Vanguard, State Street and Fidelity—are big in passive management. They want to do things their own way. Their absence from the list of participants in PRI activity was quite a surprise for us. We thought it would be natural for them. But they have their own networks and work through entities like Focusing Capital on the Long Term (FCLT). The

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number of people who work on ESG-related issues is much smaller at the Vanguards and Blackrocks per billion dollars of assets. The department is somewhat bigger in terms of number of people, but it's spread over a larger volume of assets, so the attention that can be given by a coordinated group of mid-sized investors is rather high.

"It worries me that I am observing a huge polarization in ESG issues. Already good companies become even better. Engagements are already with companies that are exemplary. But there's a lot of companies that stay laggards. The difference could get bigger and bigger."
– Dr. Oğuzhan Karakaş

Li: We find that when the investor has internal staff designated for engagements, they are more likely to achieve success. We can infer that if the asset manager or owner is more active overall and they have designated staff for engagements, they are more likely to have success.

Peter Branner: You can have responsible investing in index products. A solid index construction process is required when pursuing multiple, responsible investment goals while still delivering long-term performance consistent with a broad market benchmark. For demanding, responsible investors, the value of such a product is consequently mostly in the index construction process itself and less in trade execution.

Karakaş: Peter makes a good point. There are interesting studies that show if a company has lots of passive ownership and an activist targets them, if they [shareholders] can agree on the goal, they can act together and become a good team. For the moment, this is in the early stages, but it can be worked out.

Barry Gillman: With regard to this issue of the smaller vs. larger organizations and the resources, I'm interested in comments from anybody on how much resources do you actually need to do the job.

Kim Shannon: At Sionna (Investment Managers), we rely heavily on our PMs (portfolio managers). We set up an ESG committee including portfolio managers, as well as client relations and operational staff. The committee works to understand the leading edge of some of the low-hanging fruit on governance issues and provides pointers and proposed questions to ask of management teams to uncover areas for enhanced disclosure. That material often is extremely supportive of our engagement. Additionally, we allocated a portion of discretionary compensation to all staff to underscore the importance of adding this analysis to the research effort. It goes into the incentive package to get them motivated to do more frequent engagement efforts. Fortunately, one young PM ran with it and his enthusiasm and success with it is encouraging

others. We are aware of the big pension funds who have dedicated specialists who spend all day looking at companies and their ESG scores. It's an extra burden for smaller asset managers for sure.

Peter Branner: APG (Asset Management) and its many investment professionals all have sustainability as one of the four parameters we consider towards investment decisions. So, it's not about experts and non-experts; it's the investment process itself that drives investors to secure a proper and consistent approach. In liquid assets, beyond product exclusions, we have built a dynamic framework of leaders and laggards as part of the investment processes. If a PM wants to invest in a laggard, they need to engage against clearly specified objectives. It could be justified for risk, return, cost and ESG reasons to own a laggard, as long as there is a clear engagement strategy. It is the PM's responsibility to ensure that the necessary engagement is undertaken.

> "PRI really was the biggest and first organization in the world to do [coordinated engagements]. Their strategy is proactive. They are trying to set industry standards across the world. That's why those engagements, the first ones, are trying to appeal to the bellwether firms and hoping [to] set the tone in a certain country, especially emerging markets..."
> – Dr. Xi Li

APG also employs a team of 25 dedicated corporate governance and sustainability managers. Engagement is conducted either by them or the PM or in collaboration. We even engage with policymakers and regulators and also conduct thematic engagement.

Bob Schmidt: We had one question come in via chat about this two-tiered approach. It seems the investment managers were better at being leaders vs. asset owners. Any thoughts on why?

Li: The asset owners (such as pension plans) have less pressure for asset flows. The managers need to do things to show they are active and put that into marketing to attract additional flows. So, part of the answer is reputation worry. That makes them less keen to become a lead. Also, with pension plans, the organizational and incentive structures are different. But the pension plans play a role in supporting engagement efforts. And when you have larger pension plans in the group, they do have a higher success rate. If they have a lot of assets under management, they can be influential, especially if you look at continental Europe.

Karakaş: Activism, as you know, has been around for a while. And it did start with pension funds and mutual funds—the institutional activism in the '90s and before. The research at the time found that despite all the good intentions, they could only move the needle on firm value by maybe 1%. Then came the hedge funds. The research finds they generate much higher returns. Of course, there's a big debate as to whether that's good or bad, but one explanation as to why maybe hedge funds were more successful is going back to having more focused resources, the right incentives, and access to more sophisticated investment tools such as shorting and derivatives. I guess we're seeing a similar pattern here.

But one other point—I see the earlier hedge fund activism like being a math teacher. They check the companies with questions like: Are you paying your dividends? Is leverage right? They ask what is 2+3 and if they get the answer of 5, then they say that's good; otherwise, they engage with the firm to address the problem they observe. But ESG activism is more like being a music teacher; they are teaching harmony—and that's much more difficult to measure and to apply. In many cases, we can't even agree on what ESG is.

Also, there is a question in the chat about laggards. This goes back to Peter's point. It is something we've observed. It worries me that I am observing a huge polarization in ESG issues. Engagements are with companies that are already exemplary, and good companies become even better. But there's a lot of companies that stay laggards. The gap could get bigger and bigger. It's almost like we're developing a new language with ESG; some people can speak it fluently and some are totally clueless. There's more room for improvement for those laggard companies. Much more could be going on to close that gap.

Li: There was another question in the chat about why engagements tend to target the big firms. PRI really was the biggest and first organization in the world to do this. Their strategy is proactive. They are trying to set industry standards across the world. That's why those engagements, the first ones, are trying to appeal to the bellwether firms and hoping that by setting the tone in a certain country, especially emerging markets, they can set the standard for the industry so other firms would follow those bellwether firms.

We cannot observe whether there is any spillover effect into other laggards in a country or region. That's on our agenda to do next—to see whether regions or countries targeted by PRI that achieved success have any spillover effect for smaller and laggard firms.

“Tailored portfolios are one thing that fairly few people do. They look at overall rankings or ratings. The tastes of investors will move with the capacity of investment managers to meet more individualized needs.”– Dr. Elroy Dimson

Barry Gillman: That's an interesting topic in terms of what's next. There's a tremendous amount of work that's been done. To what extent can your work be used by PRI in different areas? What would you like to see done? Anything else in broad directional terms that might come out of this in the next year or two?

Dimson: There are two directions that come to mind. First, catering for particular investor groups. Faith based charities provide an example. Sharia-compliant investors will, on balance, want a portfolio that's light in financials. That means they might overweight pharmaceuticals. In contrast, Dharmic investors [Hindu, Jain, Buddhist, Sikh] may avoid pharmaceutical companies that test products on living things. Catholic charities don't want exposure to healthcare businesses that facilitate abortion or birth control. One trend I foresee is growth in portfolios tailored to investors' preferences. Tailored portfolios are one thing that fairly few people do. They look at overall rankings or ratings. The tastes of investors will move with the capacity of investment managers to meet more individualized needs.

At another level, there are aspects where we are more likely to all agree. I think that's having an effect, as well. Things that nobody likes—such as excessive fossil fuel and carbon exposure—a number of those investments are being taken private. (Bizarrely, that means that some assets will be passed back to investors who didn't like a company when it was publicly listed, even though you don't really know what's going on when you have assets wrapped up in a private portfolio.) You could see movement given general tastes in the types of assets people hold.

Karakaş: Barry, with your question, one of the interesting applications is Climate Action 100+. [More information here.] Institutions come together and engage with companies that have the highest carbon emissions; they target the largest 100 and then go after the next 100. I'm observing that in some sense Climate Action 100+ is an initiative confirming what we showed with this paper as best practices for coordinated engagements: having a two-tiered structure, a leader and supporting players, and coming up with a clear objective.

On the climate change side, it seems that investors go for the lowest-hanging fruit. Currently, I see that carbon is somewhat being treated like sugar in diets, and companies are going after zero carbon diets. But what comes next? It is possible that such single-faceted diets may prove less effective than desired. It's the much more difficult issues of measuring social change. That will be the next item. There will be some reckoning as focusing on just one thing is not good for overall health; we should have more of a holistic approach.

Li: As Oğuzhan mentioned, climate change is one of the hottest topics. One major reason is carbon emissions are quite easy to measure. The Paris Agreement makes this an easy, tangible target. But in recent years, there have been a lot of other movements from the labor side. For example, with the pandemic, we are talking about employee safety, mental health and the #MeToo movement. So, I think especially in Europe, issues like the gender pay gap and Black Lives Matter are also pushing the agenda of social aspects. But compared with the environment, social issues are behind, primarily because of the lack of tangible measurement when you talk about social issues.

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