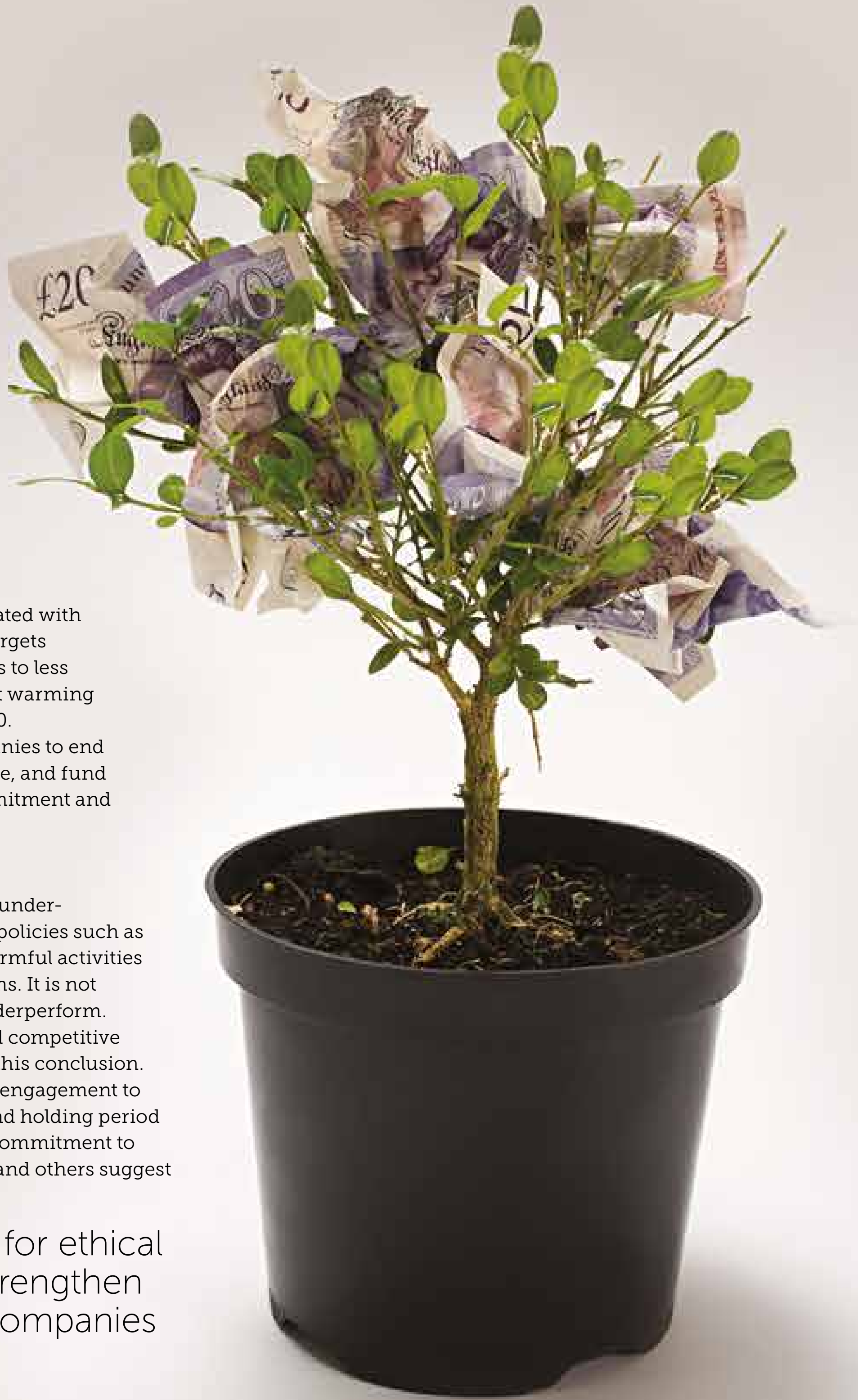

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The rules of engagement

Quintin Rayer offers tips for ethical investors that want to strengthen their engagement with companies

Ethical and sustainable investors focus on issues such as environmental, social and governance (ESG) factors, UN Sustainable Development Goals and traditional areas such as alcohol, tobacco, gambling, pornography, armaments, nuclear power, animal testing and intensive farming.

Many investors are also acutely aware of the increasing likelihood of extreme weather events and other challenges associated with global warming. Despite Paris Agreement targets to hold global average temperature increases to less than 2°C above pre-industrial levels, current warming appears to be on track for at least 3°C by 2100.

Many fund managers engage with companies to end harmful practices. Yet engagement is opaque, and fund selectors struggle to assess managers' commitment and progress made.

Engaging for a 'green rinse'?

Concerns that sector exclusions can lead to under-performance may motivate less categorical policies such as engagement, underweighting firms with harmful activities or overweighting those that support solutions. It is not obvious that ethical investments should underperform. Ethical strategies may offer reduced risk and competitive advantage, with several studies supporting this conclusion.

Many ethical investors state that they use engagement to influence companies. While position size and holding period help, it is tough to appraise the quality and commitment to engagement work. Discussions with NGOs and others suggest this vital area is significantly under-assessed. A stronger focus on engagement is essential, especially for it to be a key tool for addressing issues such as climate change.

Difficulties appraising engagement quality can lead to fears of greenwashing – engagement could be a 'cosy chat' with management, with no real prospect of company action. Fund managers may fear to confront boards in case they damage relationships, reducing access to corporate information.

Strengthening engagement

Many mutual funds outsource voting to proxy firms, passively following their guidance more than 95% of the time. This appears weak, particularly if managers are not even formulating their own views. Funds should be defining in-house voting policies. Stronger approaches might involve proposals linking director remuneration to issues of concern or resolutions that formally instruct directors to address them.

Engagement should involve more than voting; a two-way dialogue is required. Ethical investors should discuss legitimising standards and their expectations, and follow up with boards. They may need to identify issues and develop the expertise to actively educate boards on emerging problems.

Fund managers need non-confrontational ways to raise contentious issues without damaging relationships with boards. Identifying and sharing best practice may be one approach. Sector benchmarking might be another, with robust assessments shared anonymously or published as circumstance permits.

> "Stronger approaches might involve proposals linking director remuneration to issues of concern"

Engagement escalator

When overtures do not produce results, managers should follow an escalation pathway, involving progressively more assertive engagement practices. Follow up initial meetings with collaborations with other investors, public statement of concerns, voting against boards or, ultimately, divestment.

Some fund managers may see voting against boards as evidence of engagement failure. However, boards should not expect to be able to take institutional shareholder support for granted. Like divestment, engagement is likely to be more effective when backed by the credible threat that you are prepared to oppose board resolutions. Discussions with boards before and after voting could help place voting decisions within a more constructive context.

For impactful engagement, fund managers will need to allocate significant resources to researching issues thoroughly. They will be able to present problems to boards, together with possible solutions. If boards find that engagement discussions with investors become a valuable source of information on business challenges, perhaps tricky conversations can be used to strengthen, rather than damage, relationships.

Sound investments

How to exert positive pressure

Be prepared to escalate engagement if initial overtures do not produce results

Appraise your organisation's quality of, and commitment to, engagement

Funds should be defining their own in-house voting policies

Tangible results

Fund managers carrying out engagement need to ensure it has an impact. Tangible results are necessary, particularly as engagement quality is hard to assess.

A global climate crisis is emerging, with fossil divestment or engagement proposed to help promote the transition to a low-carbon economy. If engagement quality is opaque and results appear inadequate, investors will drop engagement as a tool in this crucial area. Fund managers need to ensure that engagement produces meaningful outcomes.

However, engagement and divestment need not be competing opposites. Divestment or engagement need not be justified as if everyone followed the same approach by adopting a Kantian imperative. Individual investors are not the entire market, and a credible divestment threat is an important part of engagement. Those investors who divest and clearly say why give strength to those continuing to engage.

To read a version of this article with references, please visit bit.ly/2QhNEnZ

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