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Managers must use 'credible threat' of divestment to engage boards

In a world of climate crisis, proper engagement and divestment do not have to be at odds with each other

By Quintin Rayer
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Many fund managers engage with companies to end harmful practices. Yet engagement is opaque, and fund selectors struggle to assess managers' commitment and the progress companies make, if any.

That said, concerns that screening could lead to under-performance may motivate advisers to pursue a less blanket approach. This could involve the lobbying of fund managers, the underweighting of firms with harmful activities, or the overweighting of those that support solutions to the world's problems.

Many ethical investors state they use engagement to influence companies. But while position size and the holding period help, it is tough to appraise the quality and commitment of a firm to engagement work. A stronger focus on engagement is essential, especially for it to be a key tool for addressing issues like climate change.

Difficulties with appraising engagement quality may also lead to further concerns about 'greenwashing'. Engagement could be a 'cosy chat' with management, with no real prospect of corporate accountability for the actual impact of a fund that claims to be ethical or sustainable. Fund managers may also be scared of confronting boards in case they damage relationships, which could itself in the long run reduce the access they do have to corporate information.

Do it yourself

If media coverage is to be believed, many mutual funds outsource voting to proxy firms, passively following their guidance over 95% of the time.

This appears to be a particular weakness, particularly if managers are not even formulating their own views. The fact is that managers should be defining in-house voting policies themselves. Stronger approaches might involve proposals linking director remuneration to issues of concern, or resolutions that formally instruct directors to address and answer impact concerns.

But even with all that, it must be said that engagement should involve more than voting. A two-way dialogue is required. Ethical investors should articulate legitimising standards, their expectations, and follow up with boards, who should respond. They may need to identify issues and develop the expertise to actively educate boards on emerging problems. All that takes time.

For their own part, fund managers specifically need non-confrontational ways of raising contentious issues with boards without damaging relationships. Identifying and sharing best practice may be one approach. Sector benchmarking might be another, with robust assessments shared anonymously or even publicly, where circumstances permit it.

Escalating the situation

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

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. They do not have a right to their money. Like divestment, engagement is likely to be more effective when backed by a credible threat of being prepared to oppose board resolutions. Discussions with boards both before and after voting takes place will likely help create a constructive environment, in which nobody is caught by surprise.

Again, all that takes time and resources. For impactful engagement, fund managers will need to allocate significant resources to research issues thoroughly. If they do that, they will be able to present problems to boards together with possible solutions. If boards find 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.

Measured threat

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

This is all the more important, given that 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.

Finally, engagement and divestment need not be competing opposites. 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.

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