Return on Engagement: How to increase your ROE

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We spoke with a number of key players around the world on both sides of the table to get their take on where we are in the engagement landscape today, where we should be in five years’ time, and what changes need to happen for us to get there. All of our experts agreed that the relationship between companies and investors has advanced considerably over the last decade, with David Frick, Senior Vice President of Corporate Governance, Compliance and Corporate Services at Nestlé, stating that it is “night and day from ten years ago.”

As many will recall, back in 2007, Peggy Foran, then the Chief Governance Officer at Pfizer (now Chief Governance Officer, Senior Vice President & Corporate Secretary at Prudential Financial), announced that the Board leadership would meet with company’s top 35 investors. One very prominent law firm put out a memo the next day calling it “governance run amok.” Much progress has occurred in the ten years or so since this initial meeting. That being said, while there are “improved resources on both sides” systemic and structural challenges still need to be overcome, according to Mr. Frick.

Investors broadly agreed that ESG engagement has improved, becoming more integrated across firms. Still, how asset managers approach ESG engagement is largely determined by their investment strategy. As such, there is a dichotomy between active and passive managers, with ‘stand-alone’ stewardship teams playing an increasingly important role at the passive shops, while

Ten years on from the financial crisis, much progress has been made in the dialogue between companies and investors, but there is still a sense that the two sides are speaking different languages; the gap between them has not yet been bridged.
ESG is being more integrated in the investment teams at active managers.

But all agreed gaps remain. “Institutional investors have become very good at reactive, crisis-driven engagement” according to Harlan Zimmerman, Senior Partner at Cevian Capital, the European activist fund, however, mainstream investors’ capabilities in proactive and directed engagement are more “uneven.” Hermes EOS Executive Director Hans Hirt felt that there was still much room for improvement and that pressure would continue to be exerted by asset owners on their asset managers to ensure that effective, value-added engagement occurs.

**Legacy of the crisis**

In part, the failure of communication arises because different organisations – both companies and investors – seem to mean different things by engagement. Some are still trapped by the outcome of the financial crisis – where regulators stepped in to help address the breakdown of trust that characterized the crisis and its aftermath. The rules-based approach included Say on Pay in the US (through the 2010 introduction of Dodd-Frank) and similar requirements around the world, driving a new intense bout of engagement focused on pay, and largely from the company perspective focused on getting pay votes passed. For investors the huge workload associated with reviewing, voting and engaging on complex pay plans became the “be careful what you wish for” era of stewardship.

In the first five years following the introduction of Dodd-Frank in the US in 2010, and its Say on Pay requirement, the inbound engagement requests to major shareholders increased immensely. Most were swamped. This reality has resulted in improvements to the processes that frame the current engagement landscape, as well as some related spill over effects into the substance of the discussions.

Shareholders began to craft and adopt their own stewardship codes in several jurisdictions, emphasizing their own responsibility to be accountable investors of capital on behalf of their constituents. Various collaborative efforts also materialized including the Shareholder-Director Exchange (SDX) in the US which is a “10-point guide for public company boards and shareholders that determines when engagement is appropriate and how to make these engagements valuable and effective.”

Companies, in turn, upped their engagement game: “the scope of engagement has evolved considerably over the last 5 years: it used to be about the AGM and resolutions, now it’s much more contextualized with the strategy of the company,” according to Vincent Dufief, CSR Investors Relations Manager at Total S.A.

In addition to increased face-to-face interactions, Michelle Edkins, Global Head of Investment Stewardship at BlackRock, also notes that “better disclosure is [also] a form of engagement,” underscoring the point that companies and investors are improving traditional methods of communication to rise to the challenge to be more accountable to each other as well as their respective stakeholders. Ms. Foran adds that “boards of larger companies are also asking their company lawyers to use their disclosure documents in a way that communicates relevant information to their stakeholders. You see much more
'plain-English' language, summaries, call-out boxes, videos of board members and ESG disclosure that may not be legally required but is being asked for by stakeholders. This information is being provided much more proactively than in the past.”

Enhancing resources

While the scope of engagement continues to shift, the mechanics also still need further work. According to Ms. Edkins, companies requesting engagement need to provide draft meeting agendas so that discussion topics are agreed in advance and incorporate any additional issues shareholders may wish to raise. This means that boards and those in management who support them must be sufficiently well informed as to what topics should be addressed with which shareholders and when is the optimal time during the annual cycle to have those discussions. While this certainly creates additional pressure on resources, if done properly, it can lead to improved engagement outcomes, thereby making the investment in preparation pay off substantially for both sides.

Investors also continue to improve their abilities, increasingly professionalizing their engagement teams in a variety of ways, including ramping up “sector knowledge for post-investment stewardship teams,” as highlighted by Ms. Edkins. We see this trend continuing to improve the quality of engagement in the future, increasing focus on specific material business risks and shifting away from plain-vanilla -one-size-fits-all ESG engagement.

Despite these transitions taking place on both sides of the table, challenges persist, and the next five years will be key to cementing the understanding that ESG risks and engagement around them is in fact simply engagement on material risks to businesses. The large passive investors are starting to build stewardship teams sufficient to deliver on the intention of richer dialogues. However, most agree that PMs and research analysts will be conducting engagement themselves at active managers, “but with help from specialists who know specific subject matters or markets and are experienced in effective techniques”. This will preserve “a role for a specialist team” even as integration finalizes its position in the mainstream investment professionals’ roles, according to Dr. Hirt.

As these changes occur, investors have to be clearer to the market and their portfolio companies about their dynamic stewardship structures. No two investors have exactly the same model and “companies don’t [always] understand the relationship between [various] teams at different investors”, notes Mr. Frick. Mr. Frick further stated that some corporates are also frustrated by what they feel is an endless request for more information, without always knowing precisely “how investors use qualitative ESG data in their investment analysis” according to Mr. Dufief.

The Impact of Engagement

The question that has arisen – as a result of this information gap – is whether all this engagement activity is having a positive impact from both a value-driven and values-driven perspective. If companies and investors are to continue devoting resources to these discussions and ensuing outcomes, then they must be able to provide proof points to their constituents as to the

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benefits of these ESG engagements: “The day I will be able to clearly show my CEO that an investor has bought Total shares and the share price of the company has increased thanks to our ESG policy, it will be great,” affirmed Mr. Dufief.

While corporate disclosures have increased significantly over the last decade, reporting by investors still makes it “hard to assess whether PMs are asking one or two perfunctory questions during an engagement meeting or if they’re actually having ESG-focused discussions with impact” according to Dr. Hirt. He confirms that there’s “room to move towards outcome-driven engagement and reporting in the future.”

Such disclosure will confirm to companies that the time they and their boards spend communicating about ESG strategy and risk management is impactful and will help answer the “so what” question related to all the disclosure that companies are providing, as highlighted by Mr. Dufief. This enhanced disclosure may also help companies feel more confident that their investors are “living up to their talk when it comes to long-termism,” according to Mr. Frick.

Over time, we believe this shift will crystallize the fact that constructive activism is no longer primarily an investment strategy, but is rather a behaviour of mainstream investors, as Mr. Zimmerman asserted: “I think some good institutions are getting there and the bigger, better institutions are increasingly understanding that they can have an impact in helping make companies better.”
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Upgrades that Companies and Investors Should Consider Today

The below actionable takeaways were garnered from the individual and collective expertise of the participants in our inaugural Progress Group, coupled with our own insights from our collective five decades of experience.

**INVESTORS** are expected to be accountable owners/managers and they can keep improving their efforts in the following ways:

**CLARIFY TO COMPANIES WHAT YOU MEAN BY ENGAGEMENT.**
- Is it a pre-investment activity or a post-investment discussion?
- Who will attend the meeting from your side? Where in your organization do they sit?
- Are there people other than those who will attend who will contribute content or views to the discussion you will have at the meeting?

**BE CLEAR ABOUT WHAT YOU INTEND TO ACHIEVE IN EACH ENGAGEMENT MEETING.**
- Provide feedback to the company about the meeting agenda to ensure your priorities will be covered.
- Do you want the board to take a specific action or are you building the relationship?
- How will the information gained through the engagement be used by your organization?

**RE-INVENT ENGAGEMENT PROGRAMS TO BE MORE OUTCOME-FOCUSED AND DISCLOSE EFFORTS.**
- Explaining the impact that your engagements have will help your various constituents (including asset owners, beneficiaries and private clients) support your efforts and reassure them that their voices are being represented appropriately.
- Significantly improve disclosure about your engagement activities and impact with meaningful information provided to diverse audiences, including companies. Without this, it will be difficult for companies to improve their processes to meet your evolving needs.

**FURTHER PROFESSIONALIZE YOUR ENGAGEMENT RESOURCES.**
- There is a need to continue to increase expertise in sectors to support integrated investment decision-making, whether it is pre- or post-investment.
- Seek to build relationships of trust with boards of companies about which you currently have limited or no concerns - it is always easier to establish relationships when you don’t need them.
COMPANIES need to convert their engagement programs into a competitive advantage. In particular:

**KNOW YOUR AUDIENCE.**

- Many companies still don’t understand the structure and functions of stewardship resources that investors have. In contrast, the roles of portfolio managers and analysts are well understood.
- Understand and appreciate the resource constraints of your investor base.
- Provide a draft agenda for engagement meetings you initiate.

**STOP ENGAGING FOR THE SAKE OF TICKING BOXES.**

- Educate your senior management teams and non-executive directors that ‘no thank you’ is usually good and that it can be reversed quickly depending on events.
- Focus on what matters: Engage on issues that are material to your business strategy.
- Leverage enhanced disclosure as a form of engagement.

**SOLICIT FEEDBACK AS TO HOW INVESTORS ARE USING ENGAGEMENT INFO.**

- Ask specific questions about how ESG information is factored into the investment process, whether it’s pre- or post-investment.
- Seek input on strategic options under consideration – do not go only when everything has already been decided.
- Ask investors how they think about you relative to peers and the market in general.

**BE READY FOR ACTIVISM IN DIFFERENT FORMATS.**

- Don’t expect it to look like the adversarial backdrop that has persisted until now.
- Be aware that constructive activism is increasingly backed by index followers.
- Understand that as money shifts into passive strategies, there will be more pressure on companies to improve returns.