Turn engagement into a 'win-win' situation

Engagement has long been a fundamental part of the active investment process. But we should avoid exaggerating its impact and focus on the 'win-win' for the company and investors.

By *Eugenia Unanyants-Jackson*

Trust-based, informed dialogue between investors and investees is integral to identifying risks and pursuing positive investment outcomes for clients and beneficiaries over different time horizons.

As the notion of emerging and/or unpriced risks inherent in ESG factors became more widely accepted, engagement seemed like a powerful way for investors to learn about company exposures, to understand plans to mitigate risks and to capitalise on opportunities.

However, the meaning of active stewardship and the purpose of engagement implicit in different definitions can vary considerably. These varied definitions leave plenty of room for interpretation, increasing the risk of a mismatch between the asset manager's approach to engagement and the expectations of underlying investors. It is therefore critical that asset managers define and disclose the purpose of stewardship and engagement activities from the outset.

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Focusing on value-enhancing issues

ESG engagement can be broken down into three distinct forms, all with a different focus and target outcome. Firstly, there is idiosyncratic engagement, which focuses on the challenges of specific companies – such as underperformance compared to peers, unpriced ESG risk, and long-term profitability drivers. This is typically used by mainstream investors to target areas of overlap between financial and environmental/social outcomes.

Then there is systemic engagement, which focuses on 'themes' that encompass systemic risks at global scale – like climate change.

Impact engagement, the final area, focuses on distinct issues less addressed by mainstream investors. In the targeting of positive environmental or social outcomes, investment outcomes may be of secondary importance.

Engagement at a systemic level, as opposed to the company-specific idiosyncratic level, may be driven by the same financial motivations, but may require different trade-offs for investors. Research shows engagement is most successful when it is focused on value-enhancing issues – resulting in a 'win-win' for the company and investors.

However, engaging on systemic issues may require investors to seek changes that are costly for some companies individually, but beneficial for the wider economy. This 'lose-win' scenario will face more challenges to achieving results than a win-win scenario where

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engagement is most effective.

Achieving change alone is unlikely

For investors wishing to use influence to address the many sustainability challenges our world faces, there is a strong incentive to set bold engagement goals. It is unsurprising – against a backdrop of climate change, biodiversity risk and human rights violations – that the most ambitious engagement objectives target systemic change in the economy and society.

But achieving real-world systemic change is a tall order for investors alone. It requires commitment and action from multiple actors within government, civil society and the business sector. In the case of climate change, for example, companies need a supportive public policy environment, stability, long-term incentives to invest in economic pathways and robust business cases for transition. No single company or investor can achieve systemic change in isolation – collective action is necessary.

However, if collective action misses the mark, a misalignment of interests may arise between investors seeking to address systemic risks and companies focused on their own survival and prosperity. For example, the engagement goal of Paris Climate Agreement alignment by 2050 may be too ambitious if targeted companies see certain engagement and expectations as unprofitable or economically unviable in the context of current government policies.

Engagement goals misaligned with economic reality can also create conflicts of interest with clients who do not have the mandate to give up returns for sustainability outcomes.

A natural alignment of interests

The unique strength of an active asset manager is the depth of engagement made possible by their extensive knowledge of a company. Active managers are also well-positioned to communicate the investment objectives of their clients and beneficiaries to investee companies. Because of this, many active investors prefer to approach company engagements in a more targeted way, linking objectives to a specific financial or operational concern or opportunity for the company.

Such a tailored approach to engagement is more likely to resonate with company management and lead to a lasting change in the company’s strategy or practices. It is also more likely to succeed when issues targeted by engagement are financially material to the company, which creates a natural alignment between the interests of the company and its investors.

While an investor should be able to evidence enacting engagement on a particular topic with a company, they can rarely claim unilateral credit for how the company has decided to act. If an engagement is successful, it is likely underpinned by many individual and collaborative investor engagements across asset classes. We believe investors need to be careful in claiming real-world outcomes as ‘their’ doing. Such claims lead to unrealistic expectations when it comes to the influence and effectiveness of investor engagement.

Asset managers cannot solve all the world’s complex issues, but by fulfilling their essential fiduciary responsibility to clients and stakeholders alike, they can play an important and critical role in allocating capital to companies that respond best to the risks and opportunities inherent in the transition to a more sustainable world. ■

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SUMMARY

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It is also more likely to succeed when issues targeted by engagement are financially material to the company, which creates a natural alignment between the interests of the company and its investors.

Investors need to be careful in claiming real-world outcomes as ‘their’ doing.