PGIM

ESG

GREAT EXPECTATIONS

Is engagement living up to its promise?

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GREAT EXPECTATIONS

Is engagement living up to its promise?

Is 'engagement washing' poised to be the next term maligning asset management's ESG movement? Institutional investors often engage with companies they invest in to improve those companies' environmental, social and governance practices— rivalling capital allocation as a core mechanism for achieving sustainable investment outcomes. But do engagement activities really deliver impactful, positive, real-world outcomes?

As a growing number of institutional investors make ambitious sustainability commitments, the volume of engagement activity reports grows with them. Company interactions on sustainability topics are commonplace, the range of engagement themes has widened, and goals have become loftier. Meanwhile codes of best practices are evolving to encourage a focus on real-world outcomes in engagement reporting, in contrast to the investment outcome focus of just a few years ago.

Yet, there is a growing realisation – and genuine bewilderment – that engagement for positive sustainability outcomes is not living up to the expectations of its proponents. When it comes to mitigating the negative impacts of certain economic activities on our environment and society, engagement can be influential, but it is rarely transformational—and an engagement expectation gap is emerging.

So how can asset managers engage for positive environmental and social impact with authenticity? How can clients navigate the landscape of engagement numbers, promises and real-world aspirations? Can we cut through the rhetoric to bring clarity to the true role of engagement?

WHY ENGAGEMENT MATTERS

Engagement has long been a fundamental part of the active investment process. 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 the perfect way for investors to learn about individual companies' exposure and understand their plans to mitigate risks and capitalise on opportunities.

And yet, the meaning of active stewardship and the purpose of engagement implicit in different definitions can vary considerably: from the PRI's emphasis on the role of engagement to enhance "the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend" to the Investor Forum's definition of "preserving and enhancing the value of assets with which one has been entrusted on behalf of others" (see end notes for full definitions).

These varied definitions leave plenty of room for interpretation, increasing the risk of a mismatch between the investor's approach to engagement and the expectation of their clients and beneficiaries. It is therefore critical that asset managers define and disclose the purpose of their stewardship and engagement activities from the outset. This provides transparency around their inherent motivation in pursuing dialogue with investee companies and sets an expectation about what outcomes such dialogue is likely to achieve.

As these definitions highlight, the role and meaning of engagement can vary and result in a wide range of outcomes. Clarity of approach and objectives is key if clients are to differentiate between asset managers and ensure that their asset manager's stewardship approach is aligned with their own stewardship and sustainability objectives.

THE FOCUS OF ENGAGEMENT

ESG engagement can be broken down into three distinct forms, all with a different focus and target outcome:

- **Idiosyncratic** – Focuses on the challenges of specific companies, e.g., underperformance compared to peers, unpriced ESG risk, long-term profitability drivers. Typically used by mainstream investors to target areas of overlap between financial and environmental/social outcomes.
- **Systemic** – Focuses on "themes" that encompass systemic risks at global scale, e.g. climate change. Targets the wellbeing of the wider economy.
- **Impact** – Focuses on distinct issues that are less well-addressed by mainstream investors. Targets positive environmental or social outcomes; willing to accept trade-off of investment outcomes if required.

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.[1] Research shows that engagement is most successful when it is focused on value-enhancing issues; a win-win for 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 engagement is most effective.[2]

Yet for those who want to use their investment 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.

Achieving real-world systemic change, however, 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 supportive public policy environment, stability, and 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.

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 Accords alignment by 2050 may be too ambitious if targeted companies see certain engagement asks and expectations as unprofitable or economically unviable in the context of current government policies. Engagement goals that are misaligned with economic reality and the trajectory of government policies can also create conflicts of interest with clients who do not have the mandate to give up returns for sustainability outcomes.

To be successful, engagement goals for individual companies should be grounded in the economic and political reality in which the company operates. As previously noted, it is most realistic to focus on sustainability outcomes that are achievable and value enhancing for the company and its investors. Setting realistic expectations for the outcomes of engagement in this context means ensuring that these goals are:

1) **Meaningful** to the management team by being additive to the long-term objectives of the company.

2) **Attainable** whilst using existing technologies cost-effectively.

3) **Value enhancing** for companies and investors.

It becomes clear when viewing engagement through the lens of these three core tenets that the expectations of investor engagement on systemic risks can be difficult to meet. For example, given the importance of international treaties and government policies in achieving global and country-specific net zero goals, there is a strong argument for focusing systemic risk engagement on public policy, whilst targeting more idiosyncratic engagement goals at the individual company level.

TRADE-OFF BETWEEN BREADTH AND DEPTH OF ENGAGEMENT

In a time of high expectations and growing engagement numbers, thematic engagement appears to be the prevailing trend. The quantity of engagement interactions or a proportion of portfolio holdings covered by such an approach are often seen as proxies for impact.

But the relationship between the breadth and depth of engagement activities is complex. It is important to be mindful that both broad engagement campaigns and in-depth company dialogue can play positive, albeit very different roles, in achieving desired engagement outcomes.

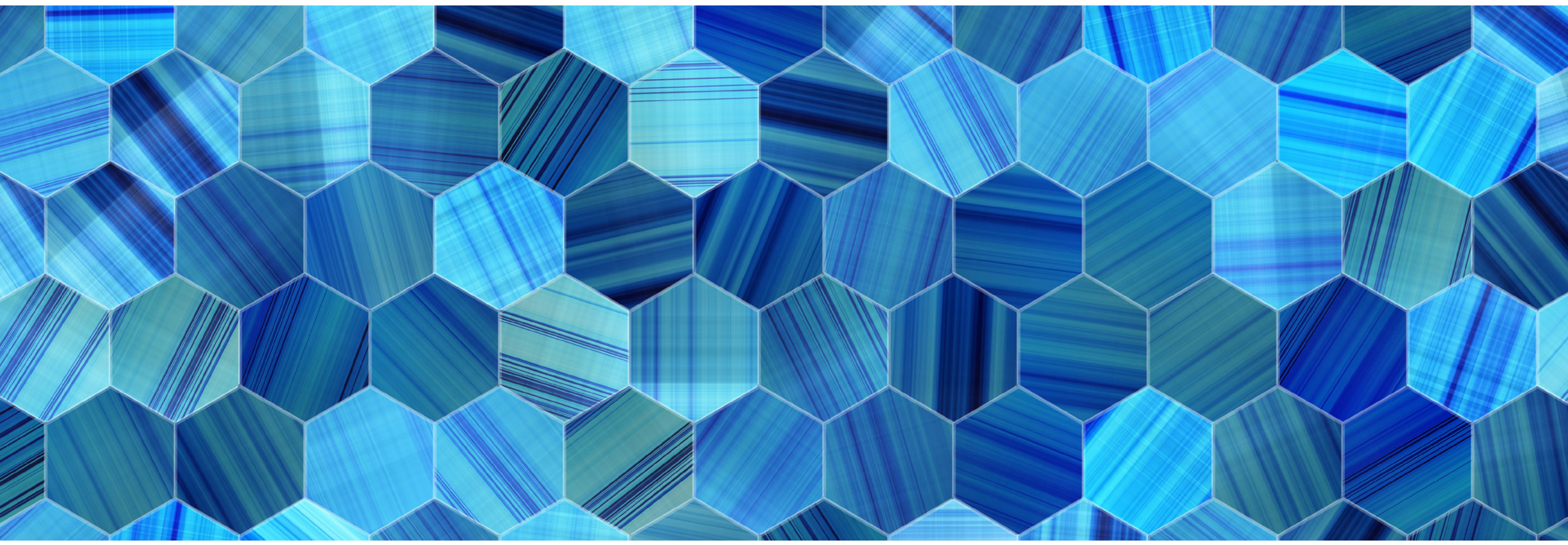
Broad, often thematic, engagements can help raise awareness among companies regarding emerging risks and issues of importance to their investors. When combined with proxy voting activities, they can quickly get the attention of companies' boards and management. But stewardship resources are finite; achieving broad coverage may necessitate a 'cookie cutter' approach that focuses on common risks within a sector or geography, at the expense of addressing idiosyncratic issues at each individual company. As a result, companies are likely to be less motivated to act if the link between the engagement ask and the commercial benefit to the company is weak.

The unique strength of an active asset manager is the depth of engagement made possible by their extensive knowledge of each individual company in a portfolio, which includes each company's business model, leadership team and style, operational activities, competitive advantages, financial performance, and industry landscape. Active managers are also uniquely 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 much more targeted way. They link their engagement objectives to a specific financial or operational concern or opportunity for the company, and make clear how fulfilling a particular engagement objective would benefit the company and its investors.

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.

Investors should use engagement approaches that are best aligned with their investment style and be transparent about the strengths and limitations of such approaches. Furthermore, there should be less emphasis on the number of engagements and more on client outcomes—whether they advance financial or sustainability objectives.

"Many active investors link their engagement objectives to a specific financial or operational concern or opportunity for the company, and make clear how fulfilling a particular engagement objective would benefit the company and its investors."



TARGETING THE RIGHT KIND OF OUTCOMES

Effective engagement can add value for many stakeholders: for companies, investors and in some cases for the environment and society. The notion of investors using their influence to achieve real-world impacts and help deliver global collective goals, such as Paris Climate Accords alignment, is attractive to many stakeholders. However, as detailed above, it comes with significant challenges: not least proving a causal link between an investor's engagement and the real-world change.

Investors do not run the companies they invest in, nor do they have control over how investee companies may respond to their engagement asks. So, whilst 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. Of course, there are instances of high-profile activist campaigns where such claims can be reasonably made, but these are exceptions.

In view of these challenges, 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.

A pragmatic asset manager would undertake engagements where they have identified issues that are likely to impact the value of their investment, with the objective of prompting action from the company management to address such issues. The management actions (or the lack thereof) within an appropriate timeframe lead to an investment view, which can be positive (e.g. maintaining or increasing exposure to the company's equity or debt) or negative (e.g. reducing or eliminating exposure to the company).

By focusing engagement efforts on outcomes directly linked to their investment strategy and performance objectives, investors are more likely to influence positive change. Such investment focus will lead to setting engagement goals that are not only attainable for companies and resonate with management, but, importantly, target areas where investors are best placed to catalyse that desired change.

This philosophy hinges on three core beliefs:

1) **Issues that are not material to the company, its operations, its markets or its key stakeholders are unlikely to impact investment outcomes.** Areas where negative environmental or social impacts translate into risks or opportunities are more likely to gain traction with boards and management of investee companies.

2) S**earching for positive alignment between engagement goals and investment outcomes** will ensure that the former are within the boundaries of economic or technological feasibility and are both attainable and value-enhancing for companies.

3) **Linking engagement goals with investment views** to explain how the company's actions or inaction may impact valuations, credit ratings, portfolio positions, appetite for new issuances, buy and sell decisions or eligibility of the company's equity or debt for sustainability/impact focused strategies provides valuable insights for companies. It offers a more nuanced understanding of how the issues raised in the process of engagement influence the attractiveness of their company to existing and future investors.

It is not a philosophy without limitations. There are environmental and social issues that have not yet become material enough for many companies, and would therefore fall out of scope in the short to medium term. Biodiversity is one such example; we believe the impact of biodiversity loss on businesses is largely underestimated and unpriced. But this gap between negative environmental and social impacts and their financial materiality to companies is already closing though regulatory and voluntary efforts (e.g. the European Union's Corporate Sustainability Due Diligence Directive and the international initiative Taskforce on Nature-related Financial Disclosures). Shifting customer, employee and investor behaviours are likely to shrink the gap even faster. Meanwhile, as more institutional investors embrace the 'double materiality' approach and start setting both financial and environmental/social objectives for their investment mandates, the focus of engagement will expand to a broader set of investment objectives.

Despite its limitations, an approach in which engagement goals are set by reference to investment views and outcomes will be most authentic and most effective in driving positive change while delivering investment benefits in line with the fiduciary and contractual duties that asset managers owe to their clients.

BEING REALISTIC ABOUT ESCALATION MECHANISMS

Much reporting is required on the escalation of engagement activities, yet there is insufficient recognition that these mechanisms may be too weak to lead to a meaningful change in company behaviour. In fact, there are two major instruments that investors can use to encourage change; cost of capital and voting rights. These instruments work differently in different asset classes and investment styles:

- **Cost of capital:** Available to investors who are willing and able to buy or sell companies' equity or debt. This requires an active investment style as index investors are usually unable to alter their positions in response to engagement. The effectiveness of the cost of capital instrument also depends on the size of the position and general demand for securities; the smaller the position or the more liquid the securities, the smaller the impact on the company. For the cost of capital to be an effective escalation mechanism, the willingness to divest/reduce exposure/ forego participation in new issuances must be strong, large-scale, and sustained over a period of time. This is a combination of factors that rarely come to bear. The evidence supporting investors' ability to influence via the cost of capital mechanism is very mixed.[3]

- **Voting rights:** While a potent escalation mechanism, voting down a management proposal or voting through a shareholder proposal requires a large percentage of issued share capital (50% + 1 share except in the case of special resolutions where the percentage of approval required differs across markets). In widely held companies, only issues of high importance and materiality to a significant number of shareholders can lead to such an outcome. In most cases, the exercise of voting rights serves to raise issues of concern to the boards and management rather than to force companies into a particular course of action.

A more realistic view should be taken of the escalation mechanisms available to equity and debt investors. Such escalation approaches based on the asset class and investment style should be clearly disclosed to avoid creating undue expectations of their effectiveness.

REPORTING ENGAGEMENT: PRIORITISE AUTHENTICITY OVER HYPERBOLE

Given the importance placed on engagement to deliver the sustainability objectives of many investors, requirements and expectations for engagement reporting have grown substantially over the past few years. Investors are increasingly encouraged to report on the number and format of their engagement activities on an annual basis, including case studies highlighting how they have contributed to real-world outcomes.

But the quality of engagement cannot be measured in a number of meetings or interactions, especially when it comes to claiming agency for creating real-world outcomes. So how can asset managers report on their engagement activities in a way that accurately reflects their effort without exaggerating outcomes?

The answer goes back to the link between engagement and investment views. The reporting of engagement activities should be accompanied by an explanation of how specific engagements have influenced investment views and how they helped to achieve clients' investment objectives. This would enable asset managers to highlight the breadth and depth of their engagement activities *and* the link between the outcomes of their engagements, including real-world outcomes where applicable, and their investment process. In this way, asset managers can be authentic by being very clear on what they have truly controlled i.e. their actions and their investment decisions. This can help alleviate concern that engagement goals might be detached from the investment process or that engagement activities are not consistent with delivering desired investment outcomes for clients.

A positive feedback loop would likely be created in this circumstance. Once a view on an engagement outcome has been formed by an asset manager, there will be a natural incentive to communicate it back to the company. This can only lead to higher quality stewardship with greater accountability, higher transparency and a clear and strong alignment between the investment and engagement process.

SUMMARY: NEW RULES OF ENGAGEMENT

Across the world, policymakers, regulators, investors, industry bodies and other stakeholders hold different views on how engagement should be approached and reported. We believe engagement that yields positive real-world outcomes needs to be grounded in the investment process, and focused on what investors can be held responsible and accountable for - namely their investment decisions.

Where investors focus on maximising the value of their investments in line with their fiduciary duty, identify and raise issues that are material for their investment views, and prioritise engagement topics that are attainable and value-adding for companies, engagement can be a vital channel for effecting both investment and real-world change.

It is practically impossible to be all things to all people, and asset managers have a responsibility to resist trying. They must be transparent about the purpose of and inherent motivation behind their engagement activities and the ambition of their engagement goals. Clients must understand how their provider's engagement approaches dovetail with their investment objectives and processes, as well as the strengths and limitations of such approaches.

When it comes to engagement, quality and authenticity should be prioritised over quantity. By focusing on target investment outcomes – financial, sustainability, or both – engagement reporting can reflect how the way companies respond to engagement paves a path to achieving investment objectives.

Asset managers also have a responsibility to share their experience and views with policymakers to highlight the limits of seeking to achieve real-world outcomes through financial markets.

Asset managers and institutional investors cannot solve all the world's complex issues. But by fulfilling their essential fiduciary responsibility to clients and stakeholders alike, these investors 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.

END NOTES

Engagement Definitions

Principles of Responsible Investment (PRI): The use of influence by institutional investors to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend.[4]

The Investor Forum: Preserving and enhancing the value of assets with which one has been entrusted on behalf of others and engagement as active dialogue with a specific and targeted objective.[5]

European Fund and Asset Management Association (EFAMA): On behalf of their clients,asset managers act as stewards for the companies in which they invest, to encourage better governance and improve their financial, environmental and social performance.[6]

International Corporate Governance Network (ICGN): Investor stewardship contributes to sustainable and responsible value creation which benefits companies, investors and society as a whole.[7]

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