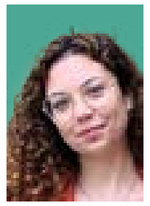
Systemic stewardship

Asset owners face risks they cannot diversify. A panel of experts from a recent all-member event discussed how to use effective voting, stewardship and engagement to navigate the challenges

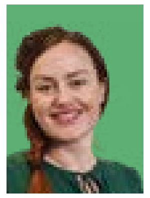
By Bruna Bauer



Institutional asset owners face systemic risks from which they are unable to diversify. Stewardship is a central activity to align with its objectives and to protect it from major risks. However, given there are over 5,000 pension funds in the UK, alongside numerous investment consultants and asset managers, the challenge lies in how to achieve this effectively in such a fragmented market.

To prompt discussion, Richard Giles, Director and Community Lead at *Pensions for Purpose*, invited Bruce Duguid, Head of Stewardship at *EOS* at *Federated Hermes Limited*, Paul Lee, Head of Stewardship at *Redington*, Tegs Harding, Head of Sustainability at *Independent Governance Group*, and Colin Baines, Stewardship Manager at *Border to Coast Pensions Partnership*, to explain their strategies on how to promote effective stewardship, including voting and escalation policy.

Promoting effective engagement and stewardship



According to **Tegs Harding**, schemes are taking a variety of approaches to stewardship. Larger funds, with higher governance budgets and better resources to magnify the topic, typically have well-structured plans based on a robust theory of change. They will be more capable of setting engagement priorities to identify 'who' they will target, understand 'how' they will engage and establish escalation measures when companies are not able to meet expectations. However, given this detailed process requires a high-level of resource, it is not viable for most schemes. For many, engagement is reduced to 'just asking a few questions to managers once or twice a year'.

Colins Baines said *Border to Coast* have established priority themes – climate, water and waste, working conditions and diversity of thought – to focus on as part of their three-year engagement strategy, determined through consultation with their 11 partner funds. Colin highlighted their interconnected engagement with voting both pre- and post- annual general meeting (AGM). However, he noted two major challenges related to the social 'S' aspect – one is breadth of social issues and managing these risks on a daily basis; the other is gaining consistent and comparable social data to assess peer companies.

Paul Lee advises defined benefit (DB) and defined contribution (DC) schemes by assessing their managers' stewardship efforts, identifying strengths as well as areas for improvement. A significant challenge lies in the huge volume of stewardship activity, especially when considering the numerous resolutions voted on by pension scheme managers. Controlling this amount of data requires technological solutions. Interpreting engagement activities and translating anecdotal reports into meaningful assessments for asset owners presents another challenge. Policy work is crucial for addressing systemic issues, but he pointed to the inconsistency between policy responses and managers' actions in company interactions, particularly climate change disclosures – this disconnect raises concerns from a systemic perspective.

Bruce Duguid drew attention to the advantage of having a large team dedicated to stewardship. *EOS'* work includes the necessary technological tools, research support and client care. They have a team of 30 employees dedicated to meeting companies on their clients' behalf, and open and direct conversations with around 500 companies a year.

Their stewardship services encompass their own assets, but also those of a diverse range of third-party clients (about 70, predominantly asset owner, clients). Collectively, these clients elevate the total assets under representation to £1.4tn. This expansive portfolio gives their stewardship team advantageous resources to execute stewardship practices according to their vision. While smaller entities can wield influence given sufficient resources and voice, Bruce recognises the size of *EOS*' assets under advice helps amplify their impact.

Clients, stemming from diverse regions including Europe, Japan, Australia and North America, help shape their approach. Bi-annual meetings, supplemented by regular conversations, guided the evolution of EOS' engagement strategies and influenced the development of new service offerings. Currently, *EOS* are refining how they report the outcomes of engagements and address the challenges of aggregating data to provide a full understanding of their service's overall impact.

Finding reliable sources of data is a common challenge, so a large research team is often needed. While establishing important goals, such as net-zero

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targets and a biodiversity strategy, are necessary, understanding the steps to build on that and how to move on with objectives is essential.

Engagement on climate change

Considering the magnitude of climate change, should we reconsider how we engage with investee companies? According to Tegs, there are two major issues, corroborated at COP26, limiting the finance system's ability to be an instrumental player in the fight against climate change. These, and other, challenges are connected to the need for a more systematic move across the industry.

- **Inconsistent rules for disclosure and target setting for companies:** unless the entire economy adheres to a uniform set of assumptions and regulations, financial services alone will not achieve the net-zero goal. Trustee boards are engaging through numerous asset managers with thousands of companies. As a consequence, organisations are receiving inconsistent requests from all parties and are struggling to respond to the expectations imposed by different institutional investors.
- **Inconsistent investment advice:** generally, consultants are failing to help trustees navigate these complexities. Many tend to overlook scientific insights and do not articulate a robust theory of change.

Climate change voting policy

For the 2024 AGM season, *Border to Coast* have formalised in their voting policy a presumption to vote in favour of shareholder resolutions that are aligned with meeting the goal of the Paris climate agreement. They recognise climate change poses a critical risk and welcome how many companies have adopted net-zero targets. But they now require scientifically aligned transition plans to ensure effective risk management. *Border to Coast* consider voting the most influential tool in altering company behaviour, (including targets and decarbonisation plans.) Their policy commits them to support credible net zero-aligned proposals. However, they take a 'comply or explain' approach, recognising some resolutions may be too prescriptive or unsuitable.

Border to Coast ensure they send consistent messages to companies by using uniform language in meetings, letters and voting. In this sense, it is important to support shareholder resolutions during AGMs. This should be part of day-to-day risk management, not the preserve of engagement escalation with companies.

When climate resolutions are opposed and receive little support, it contradicts calls for companies to transition to net zero. This unpredictable approach sends mixed messages and undermines engagement.

Systemic risks

Paul noted systemic risks cannot be diversified away from. While climate change is central, he insists on the importance of distinguishing between systemic and non-systemic risks, and differentiating the risks that can cause impacts across portfolios and markets as a whole, affecting long-term investment returns. Apart from climate change, he draws attention to rising global inequality, which is hampering economic growth, reducing social cohesion and affecting security issues. Such systemic risks cannot be ignored and have huge potential to impact investment portfolios. Paul suggests the prioritisation process should echo beneficiaries' interests.

Integrating voting and engagement

Colin mentioned the need for voting and engagement alignment to ensure board accountability and quality transition plans. Robust voting policies and engagement escalation strategies are essential to convey messages effectively. For instance, *Border to Coast* have a policy of voting against companies materially failing *Climate Action 100+* indicators. Last year, it led them to vote against the chairs of oil and gas companies. Paul also explained the importance of using standard AGM resolutions, including report and accounts, auditor reappointment and remuneration, to send messages about climate alignment. He highlights the importance of considering all resolutions, not just board appointments, in the pursuit of sustainable corporate behaviour.

Is it better to stay invested & engage?

Bruce relayed how clients frequently ask *EOS*' opinion on whether to stay and engage or divest, and if there is a 'tipping point'. Their usual response is it's for the client to determine their position on divestments. However, he raised several considerations. Firstly, the need for most investment strategies to ensure divestment strategy will lead to improved long-term financial outcomes before committing to it. Divestment can help clarify public policy/advocacy, if unencumbered by the need to seek commercially manageable policies.

Divestment raises challenges, though – it is no longer possible to engage with the company and

Feedback from the audience: breakout rooms

Engagement

During this session the audience broke into groups to discuss strategies for effective engagement and how they vary depending on the stakeholders involved.

- Good collaboration is beneficial, but what works best is to prioritise areas where individuals have specific knowledge on effective engagement.
- Structuring engagement within the framework of long-term financial success for companies is essential.
- Setting clear milestones and implementing robust policies, including escalation plans, are the key to successful engagement.
- The approach to engagement may vary based on the asset class and whether engaging with entities at the corporate level or policymaker/regulator level.

Stewardship

What are the main stewardship challenges?

- Language and definition, using complicated terminology and jargon may cause misunderstanding by end beneficiaries.
- Limited resources and time.
- Misalignment of priorities.

and the solutions?

- Education is crucial to address language and definition issues.
- Aligning incentives between trustees and company directors, possibly through changes to company law, to address priority misalignment.
- Investment networks are a way for asset owners to collaborate on aligning priorities and considering materiality.

Strategies

Ways to work effectively for engagement across investment consultants, managers and trustees?

- For investment consultants, outlining clients' expectations, understanding what a pension fund really wants and needs, but also understanding limitations are important.
- Managers should ensure the needs of pension funds aligns with their own capabilities.
- Trustees can influence alignment by understanding managers' priorities and realistic opportunities.
- Additionally, trustees could influence managers' voting practices, potentially aligning them or parting ways if necessary.

Improvements

Ways to improve effectivness in stewardship with investment consultants, managers, trustees?

- Implementing tools to measure genuine efforts and ensure accountability.
- Implementing quarterly, affordable reporting systems to track engagement and enforce consequences when expectations are not met.
- Ensuring integration and effective communication between stewardship and investment teams, with concrete reporting and tangible actions.
- Good dialogue about investment alpha, while taking practical steps to achieve long-term stewardship goals, to motivate and align teams.

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communication usually leads to positive change even if all initial objectives are not achieved. Engagement on climate change has led to many improvements compared to the 'business as usual' approach of past decades – while aiming for a 1.5°C target seems ambitious, staying below 2°C would still be a significant achievement compared with the outlook from the noughties. In that sense, he recognised investors have established science-based targets and net-zero initiatives globally, influencing policymakers in the process.

Finally, he highlighted an important consideration in discussing divestment from energy-intensive companies, especially European oil and gas firms. Divesting away from those holdings, which for *EOS* is up to its client to determine their position on, can actually threaten transition efforts as the new investor base may care less for transition strategies. It is therefore crucial to consider the specific characteristics of different industries and the capital requirements for transitioning; societal reliance on these industries is also significant and cannot be ignored.

Evaluating manager's performance

According to Tegs, trustees face challenges in reviewing manager performance, calling for high-quality advice due to the significant amount of data involved. Soft indicators, such as the language used by managers to convey their ambitions, can provide insights. Analysing their attitude to systemic issues and engagement with investee companies can also give important signs. Additionally, the resources allocated to stewardship engagement and their integration with investment teams are other important factors to consider. She lists consistency in voting policies across funds and alignment with stated net-zero ambitions as vital considerations. However, assessing actions against voiced commitments can be challenging, especially when managers support large emitters retracting climate commitments, citing prescriptive shareholder resolutions as justification. Trustees may find themselves in a frustrating position, with limited ability to challenge such responses.

Escalation policy

Colin explained the importance of having an escalation policy, which is useful to send to companies when they fail to respond or their response to engagement is inadequate. He noted that just communicating this policy with companies was often enough in itself to improve the situation. *Border to Coast's* escalation policy includes publicly declaring votes ahead of AGMs, and attending them to raise issues and file resolutions. If the investment case has also been damaged, divestment also remains an option. While this may be the last resort, it is important to keep the option on the table. Additionally, they review their policies annually, adjusting voting practices to cover carbon intensive sector voting and exclusion thresholds. For instance, they voted against 95% of oil and gas chairs in 2023 (compared to 33% in 2022), an escalation in response to inadequate transition plans from the sector.

Collaboration to increase impact

EOS actively participate in various collaborative initiatives such as *Climate Action 100+* and *Nature Action 100*. They have also contributed to seeding concepts like antimicrobial resistance and water risk with *PRI*. These efforts lead to a shared understanding of challenges among investors and enable more effective benchmarking. This, in turn, empowers those under involved in stewardship to take action.

They also align on similar concerns, such as voting against directors who exceed certain parameters. Demonstrating shared concerns garners more attention, avoiding pushback from companies. it is important to exercise caution against accusations of anti-competitive behaviour or seeking to exert control of companies – consequently, *EOS* ensure robust processes are in place to prevent such claims. Ultimately, by maintaining good practices, including ensuring that all investors' investment decisions are independently made, collaborative engagement is likely to continue to play a significant role in the stewardship world for years to come.

Bruce argued there is more to be done to prevent company directors from receiving mixed messages and to ensure a collective voice. This is especially true for medium and smaller sized investors who are often represented through their asset managers, who may not always convey their voice clearly. Enabling trustees to express their views through collaborative engagement is valuable.

Impact Lens

Our research includes published and commissioned reports. Through engagement with a range of stakeholders, we gather insights into the challenges of sustainable and impact investment. Impact Lens seeks to offer solutions and informed decisions on governance and investments. Read *Pensions for Purpose*'s latest report, 'Navigating diversity, equity and inclusion – an asset owner perspective,' sponsored by *Jupiter Asset Management, or visit our Impact Lens section*.

Trustee time and governance

Tegs noted investment issues are just one component of trustee meetings which typically occur quarterly. A mere four hours a year to address investments as a whole makes it difficult to delve into specific aspects like stewardship. According to Tegs, we need to rethink governance structures. Perhaps not everyone needs extensive teams and collaboration between organisations could be a solution. However, trustees must consider the significance of stewardship relative to the investment timeframe. For DC schemes who invest over 30–40-year periods, committing adequate governance and resources is essential.

More information

Interested in a conversation on this topic? Please e-mail Karen Shackleton.

Click to watch the video of the event.

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