



SHAREHOLDER STEWARDSHIP:

European ESG Engagement Practices 2013



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Foreword from our Sponsor



Ethical finance is not only about investing in companies and countries whose social and environmental behaviour is virtuous; by its very nature it is a participative form of finance, which aims for continuous dialogue between savers and the companies being financed. For this reason Etica Sgr has, since its founding, been an active shareholder pioneer in Italy: engagement is for us a type of financial democracy that calls upon shareholders –be they large or small– to make their voices heard and exercise their right to vote. The way engagement activities are exercised follows precise guidelines, published for the first time in 2007 and continually being updated. Our approach is based on discussion and dialogue: the objective is to ensure that companies report not only their financial performance to shareholders but also their “non-financial” impact. It is thus possible to broaden the notion of “shareholder value creation” to encapsulate a kind of global mutuality that is oriented towards value creation serving the common good. There is still a long road ahead, but we are convinced the road is one to be followed with conviction. For this reason it is a pleasure for us to make our contribution to this important publication. Happy reading.

by Alessandra Viscovi, CEO of Etica Sgr

Eurosif Foreword

Over the past few decades, the ownership structure of companies has dramatically changed. Back in the 1930s, some researchers had already observed the divorce between ownership and control in corporations. After World War II, some talked about the shift from entrepreneurial capitalism to managers' capitalism. This phenomenon has been exacerbated since the 1970s by what some people call a "sea change" in company ownership, characterized by the emergence of the asset management and pension fund industry and, thus, by the intermediation of company share ownership.

Today, the ownership of European and global corporations is held overwhelmingly by institutional owners, in large part pension funds and mutual funds. The prevalence of individual ownership of shares has dramatically diminished. By the 1990s, so-called institutional investors owned over 50% of the outstanding equity of the 1000 largest corporations in the world.

Legislators realise that one of the contributing factors to the recent global financial crisis was shareholders' lack of engagement in holding companies managements responsible for their actions. This was clearly true for financial companies involved but also companies outside of the financial sector.

The question of how agents (fiduciaries) can effectively monitor other agents (board of director of companies) is therefore more pertinent than ever.

In 2006, Eurosif produced a first Active Share Ownership Handbook with the support of the European Commission. Since then, industry practices and the regulatory context have evolved. For instance, Stewardship Codes have flourished and "SayonPay" has been heavily debated or legislated upon recently in several EU jurisdictions. New regulatory thinking seems to include the duties of shareholders, as well as their rights.

While engagement conducted by European as-

set owners and asset managers has been growing steadily for the past ten years, this growth should not mask that "assets under stewardship" represent only a small fraction of all professionally managed assets in Europe.

The first motivation to undertake this report was therefore to take stock of the evolving practices in the market and paint a holistic picture of why engagement makes sense, how it works and what outcomes can be expected so that investors or trustees who may be less familiar with it find a practical point of entry. Whilst a lot of literature and analysis has been published around the exercise of voting rights and its impediments, the corpus of literature regarding broader engagement practices in Europe seems rather limited, despite notable exceptions.ⁱ

A second motivation was to demonstrate that "smart" regulation can foster a more active approach to share ownership, which can serve both companies and investors and, in turn, the whole European economy.

Finally, a final motivation to undertake this report was to demonstrate the potential of engagement to be an agent of change. During a European SIF Exchange held earlier this year by Eurosif with its national member SIFs, it became apparent that shareholder engagement was one of the most promising and powerful tools in the SRI toolkit to foster change in the way in which companies conduct of business and to promote longer-term and constructive relationships between investors and their investee companies. This view was shared by all represented SIFs, whether rooted in traditionally engagement-orientated markets like the UK or The Netherlands or not.

With this in mind, we hope that readers will find this report to be a useful overview of engagement practices in Europe today and that it provides powerful insights about how engagement can be further fostered for more "engaged investors and sustainable companies".

Happy reading,

François Passant
Executive Director

Executive Summary

Shareholder Stewardship: European ESG Engagement Practices examines the current state of ESG Engagement in Europe. It shows how investors engage and what their motivations are for engaging with companies. In compiling this report, Eurosif demonstrates why investors find value from ESG Engagement, and in doing so, aims to encourage more investors to implement engagement on environmental, social and governance issues.

Shareholder stewardship of companies is vital in a number of respects because:

- Investors collect essential information about the company, its business practices and management strategy.
- Companies receive input from their owners about their expectations, concerns and priorities.
- Capital is allocated more efficiently when investors exert constructive oversight over companies in order to align their goals, improve business conduct and risk management, and encourage more efficient use of resources.

Shareholder stewardship encompasses many different strategies and approaches, and covers different topics ranging from strategic to reputational to structural. This report focuses on engagement by investors with companies on ESG matters, and in particular on engagement activities as a dialogue with the company. It focuses less on other engagement activities such as the exercise of voting rights.

For the purpose of the report, Eurosif has divided investor engagement activity into five phases:

- Define: Producing a policy on engagement, including the aims and topics for engagement;
- Monitor: Observing portfolio companies to identify companies at risk, and selecting targets for engagement;
- Act: Deciding on achievable objectives from engagement and an actionable strategy for engagement with each target, then initiate strategy;
- React: Evaluating the outcomes of first engagement and assessing the need for escalating the activity or adjusting the strategy;
- Communicate: Measuring the impact and value creation from engagement and communicating outcome to beneficiaries and other stakeholders.

Each of the phases are described in detail, and illustrated with case studies from investors. While not all investors have a detailed strategy for each phase, successful engagements will generally cover all the five phases, meaning that engagement should be a carefully planned and well-reasoned activity.

Eurosif finds that investors have many differing motivations for ESG Engagement. These include maximising risk-adjusted returns, improving business conduct, advancing ethical or moral considerations, and contributing to sustainable development. Many investors also see engagement as part of their fiduciary duty to beneficiaries. Regardless of the motivation of the investor, industry experts note that one of the keys to constructive company dialogue is developing a business case for change and presenting actionable demands to companies.

Investors have a number of tools and methods they can use when engaging with a company. The study finds that the most common form of ESG Engagement is individual investors engaging target

companies directly in private. The second most common form of ESG Engagement is to engage in collaboration with other investors, either in public or privately. Less common is the engagement of industry groups and policy makers, and single institutional investors engaging companies publicly. The need for investors to balance cost and impact explains why collaborative engagement is relatively common. Being able to pool resources and combine ownership stakes for the purpose of engagement can be very effective for investors, especially since it can take months or years to achieve an outcome from engagement efforts.

Many investors will measure the impact of their ESG Engagement efforts, but with differing approaches. Some will use qualitative approaches such as milestones reached or success factors achieved. Others will use quantitative measures such as improvement of company ESG score. It is rare to measure success in terms of financial performance (or alpha) because it can be challenging to separate financial outperformance caused by ESG Engagement from other factors.

Data collected by Eurosif shows that ESG Engagement has been growing fast in Europe over the last decade and now covers almost €2 trillion in assets under management. This figure, however, measures the assets covered by a policy on ESG Engagement, not the portfolio value of all companies actively engaged with. Investors will often have an engagement policy covering most of their assets, but will actively engage only on a small number of companies in relation to the total number of companies held – typically between 100 and 200 annually. This in part reflects the resource constraints of investors, and shows the need to maximise return to engagement by selecting the companies where the most impact can be expected or highest risks are concentrated. It also shows that there is room for growth in engagement, both in potential engagement and in active engagement. However, industry experts note that quality of dialogue and impact are more important than quantity when it comes to engagement, and that the figures do not capture the improved processes and increased sophistication of many investors.

ESG Engagement is a responsible investment strategy that is often used for the purpose of achieving incremental advances in sustainability reporting or ESG performance of companies. As such, it is commonly combined with other portfolio construction (security selection) strategies as a way to achieve a holistic investment strategy. The most common responsible investment strategy combined with total ESG Engagement assets is ESG Integration, which is a strategy where ESG information is combined with financial information for valuation purposes. Using data from nine European countries, Eurosif finds that almost 70% of all ESG Engagement assets are also subject to ESG Integration. The second most common responsible investment strategy combined with ESG Engagement is Exclusions, or negative screening. This finding that it is common to combine ESG Engagement with ESG Integration also supports evidence that ESG Engagement is becoming more integrated into the traditional investment process.

If one looks at the converse, or how much of the total assets of an individual responsible investment strategy is combined with ESG Engagement, the most frequent combination is also ESG Integration. Of the total ESG Integration assets in the nine countries, almost 90% is also combined with ESG Engagement. The second highest use of ESG Engagement in combination with another responsible investment strategy is Sustainability Themed investment, with 67% of all such assets combined with ESG Engagement.

Beyond investor-company engagement, the study also finds that many investors will engage with legislators and policy makers because they can have a great impact on reducing the cost of engagement by removing barriers, as well as facilitating engagement through policy initiatives. Investors will also found and support associations or interest groups that engage collectively on specific

topics such as climate change, water risk or worker rights. These are important vehicles for raising standards or generating awareness across entire industries, without the need to target each company individually.

Shareholder stewardship in general and ESG Engagement specifically is therefore an integral part of the investor toolbox for managing risk, advancing ethical values or international norms, and contributing to more sustainable companies. It is a long-term process, which requires a structured approach and patience. It can also be resource intensive, which is why few investors engage with all their companies but rather choose to focus on where the activity can have the most impact.

The key takeaways from this report are:

- Investors can best achieve positive results from ESG Engagement through constructive, strategic and targeted engagement based on sound business analysis;
- Policy makers can use a smart combination of legislation and initiatives to reduce barriers and costs to engagement, improve transparency by companies and investors and therefore better achieve some of their overall policy goals;
- Companies can build a constructive relationship with investors by enabling dialogue at board and management level, and by improving disclosure of material ESG information.

Introduction

Investors talking to companies in order to gain information or influence behaviour is the most basic form of portfolio risk management and due diligence. Only by engaging can an investor get a real feel for the state of a company, its commitment to a certain strategy, and its self-awareness of risks and opportunities.

As more and more investors are incorporating Environmental, Social and Governance (ESG) risk into investment management, and as it becomes clear that ESG risks are material to investment performance so that incorporating these issues is part of the fiduciary duty of the investment manager, engaging on ESG issues is emerging as one of the best way to exercise proper stewardship over assets.

However, most professional investors, even the large institutional ones, do not engage systematically on ESG issues. This market failure represents a serious challenge to the future stability, economic growth and sustainability of Europe.

This report on Shareholder Stewardship: European ESG Engagement Practices has been produced in order to show the state of ESG Engagement in Europe, including the motivations, enablers, barriers and practices. In compiling this report, Eurosif aims to show why investors find value in ESG engagement, and in doing so, encourage more investors to join the spread of ESG Engagement.

The study is comprised of four sections. The first section introduces the concept of ESG Engagement and details the current state of ESG Engagement in Europe. It also includes the motivations and catalysts of ESG Engagement. The second section maps out the typical ESG Engagement process used by investors. Eurosif has identified five phases of engagement, which are described and illustrated in detail. This section concludes with the consolidated map of engagement. The third section expands the discussion beyond company engagement to cover collaborative engagement and indirect engagement. The section also covers combining engagement with other responsible investment processes. The fourth section looks at how policy makers can facilitate the engagement process, and also covers views from experts on the state and future of engagement.

Throughout the report practical examples are used to clarify the arguments made. These examples are collected from public sources and their use should not be considered an endorsement of the organisations mentioned. There are also four text boxes presented separately which are designed to elucidate a particular element. In addition, there are 12 illustrations or case studies distributed throughout the report that each shows an in-depth view of a part of the engagement process. These are presented separately from the text to provide more detail to the reader. Although these case studies were developed for the report in collaboration with the respective organisations, their use should also not be considered an endorsement of the organisations mentioned. Eurosif is very grateful to all contributors to the study – both organisations and individuals. Credits and acknowledgements can be found at the back of the report.

SECTION 1

THE STATE OF EUROPEAN ESG ENGAGEMENT

1.1. Definition and Scope of the Study

Engagement is an activity that investors and other stakeholders of companies undertake in order to obtain information and influence behaviour. It is the crucial link between owners and managers that leads to better investment management, improved company behaviour and enhanced stakeholder relations. Engagement on Environmental, Social and Governance (ESG) matters is one of the Sustainable and Responsible Investment (SRI) strategies covered and measured by Eurosif in the bi-annual European SRI Studyⁱ, in which ESG Engagement and voting is defined as:

“Engagement activities and active ownership through voting of shares and engagement with companies on ESG matters. This is a long-term process, seeking to influence behaviour or increase disclosure.”

In this study on Shareholder Stewardship: European ESG Engagement Practices, Eurosif focuses on the dialogue between management and the board of companies on the one side, and the investors in those companies on the other side. The scope is limited to asset owner or asset managerⁱⁱ engagement with corporations in which they hold a financial stake, while other types of engagement, such as indirect engagement and voting of shares, are not covered in detail.ⁱⁱⁱ Stakes can be in the form of direct ownership of shares listed on stock exchanges or indirect equity stakes through, for example, indices. In addition, engagement can cover other asset classes such as bonds, private equity or real estate. This study also focuses on engagement covering environmental, social and governance issues. While much of the interaction between investors and companies is on purely financial and strategic matters, these are not in the general scope of this study.

The thesis of the study is that engagement on ESG is linked to value, insofar as the engagement with companies is based on the belief that extra-financial parameters (and strategy) have an impact on long-term value creation, and that other factors, such as reputational risk, could lead to financial risks for companies (via divestments and therefore reduced access to capital, or lost business opportunities).

Many other types of engagement exist that are not covered in detail by this study. One example is the work of non-governmental organisations (NGOs) and their direct or indirect actions to change the behaviour of companies and inform the general public of the actions of companies. It also does not in great detail cover investor engagement with policymakers in the form of lobbying, or collaborative engagement. These and other omissions are intentional, and do not implicitly mean that these other methods are less effective or important in comparison to shareholder-company engagement. For example, many shareholder engagements are initiated as a direct consequence of activism by NGOs.

The study thus focuses on the engagement process between shareholder and company on ESG issues, and the ways in which European institutional shareholders use their right to have a dialogue with the companies in which they are invested. However, it also devotes time to the notion of shareholder stewardship, and the responsibility asset owners and asset managers have to monitor and engage with investee companies on behalf of their beneficiaries. The notion of shareholder stewardship naturally extends to the voting of shares at general meetings of shareholders (AGMs and EGMs). However, this does not form the central emphasis of this report because the act of voting is substantially a reactive action without direct contact with company management, although there may be substantial engagement activity in the period leading up to the general meeting.^{iv}

The central purpose of the study is to detail and illustrate the typical engagement process of inves-

tors, to provide examples of how responsible investors implement engagement strategies on ESG matters into their fund management strategies, to show that ESG Engagement is a driver for value creation, and to inform policy makers about the barriers and enablers to engagement. In publishing this study, Eurosif aims to encourage investors to increase their engagement on ESG matters, and to substantiate the policy instruments needed to enable and promote engagement.

1.2. Assets under Stewardship in Europe

Eurosif's European SRI Study 2012 measures the assets under management that are covered by an engagement strategy on ESG issues in 14 European countries. This shows that ESG Engagement is the fourth most common SRI strategy, covering almost €2 trillion in assets.

The Eurosif survey also shows that engagement is growing in Europe, not only in terms of assets, but is spreading to new markets and is covering more asset classes than in previous years. While traditionally engagement is seen as an SRI strategy confined to equities, this is no longer the case as its application spreads especially to the corporate bond market and to real estate.^v

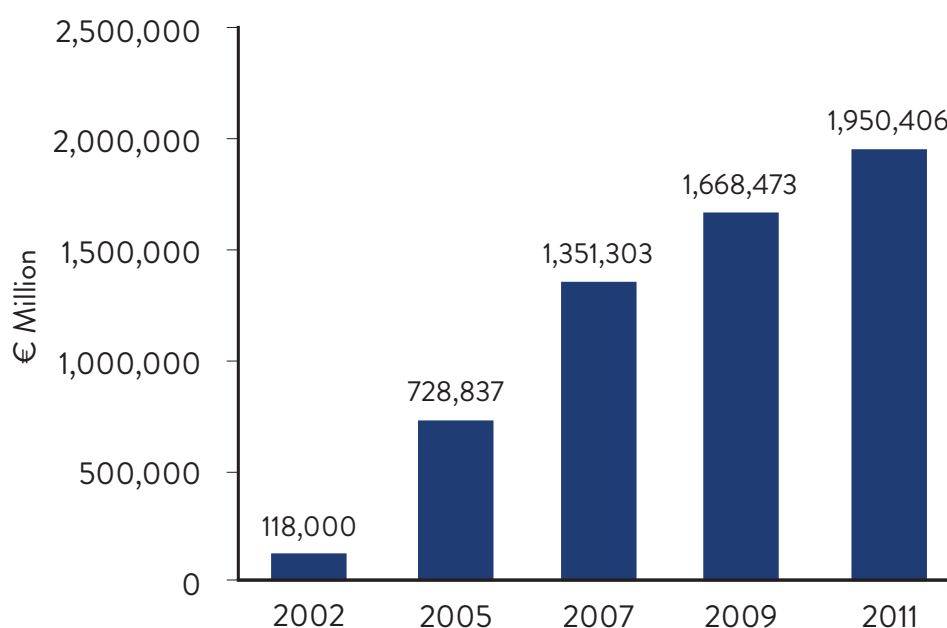


Figure 1: ESG Engagement Assets in Europe (Source: Eurosif, 2012).

Other sources also suggest that engagement is a significant and growing strategy. For example, the United Nations-supported Principles for Responsible Investment's (PRI) last report on progress from 2011 shows that more asset managers and asset owners reporting according to the six principles for Responsible Investment have an engagement policy when compared to previous years.^{vi} Of the respondents reporting both in 2010 and 2011, 66% of these have listed equities engagement policies (up from 54% in 2010) and 44% have corporate fixed income engagement policies (up from 31% in 2010).

While this may seem impressive, the overall asset management industry in Europe is estimated by EFAMA as managing €13.8 trillion. Furthermore, the total market capitalisation of listed equity in Europe is estimated at €7.8 trillion,^{vii} so even if all of these assets are held in Europe (which they are not), there is still a long way to go towards covering the majority of European listed equity with ESG Engagement.

It is also noteworthy that there is great diversity in the use of ESG Engagement across Europe. In some markets, such as the UK, there is a strong commitment to engagement. In others, engagement is a relatively recent practice. The reasons for these differences vary from market to market, but legal frameworks and culture are strong determinants of whether engagement is practiced. However, indications are that the differences between European countries are being eroded, as local asset managers implement new strategies, and international investors' engagement reach widens beyond their local markets. For example, while UK asset managers may have focused on engaging with UK companies (exhibiting home-bias), many are now also increasingly engaging with foreign companies. The table below shows the level and growth of ESG Engagement in the 14 European markets covered by the European SRI Study 2012.

€Mn	Engagement/Voting		CAGR
COUNTRY	2009	2011	2009 - 11
Austria	€ 963	€ 1,191	11.2 %
Belgium	€ 20,371	€ 19,586	-1.9 %
Denmark	€ 41,792	€ 187,718	111.9 %
Finland	€ 31,551	€ 44,870	19.3 %
France	nm	nm	nc
Germany	€ 9,190	€ 7,927	-7.1 %
Italy	€ 317	€ 18,531	664.1 %
Netherlands	€307,487	€472,019	23.9 %
Norway	€ 195,200	€ 55,652	-46.6 %
Poland	€ 0	€ 0	nc
Spain	€ 3,112	€ 11,094	88.8 %
Sweden	€ 118,760	€ 137,660	7.7 %
Switzerland	€3,461	€ 4,946	19.5 %
UK	€ 936,269	€ 989,211	2.8 %
Europe	€ 1,668,473	€ 1,950,406	8.1 %

Figure 2: ESG Engagement Assets by Country (Source: Eurosif, 2012).

Finally, it is important to note that these are the assets covered by an engagement policy (effectively potential engagement or assets under shareholder stewardship on ESG). Since asset managers typically only actively engage on ESG matters with a portion of their portfolio, the assets actively used in engagement at any given time are smaller. There is, therefore, scope for growth both in the assets under shareholder stewardship on ESG (from €2 trillion currently), and in the assets actively used in ESG engagement at any given time. For example, if an asset owner currently has an engagement policy covering 8,000 companies held, but actively engages with only 200, there is still considerable growth for active engagement by the investor.

Illustration 1: Etica SGR

This example illustrates how an asset manager uses various engagement strategies to achieve its objective.

Etica SGR (Etica) is an Italian asset management company founded in 2000 which, since

2003 has had exclusive focus on developing and promoting socially responsible investments, with the goal of promoting ethical values in financial markets.

Etica manages assets first according to negative criteria, and second with an evaluation scoring (or Best-in-Class approach). In addition, Etica engages with companies. Engagements are managed according to the “Guidelines of Shareholder Activism,” developed in 2007, and periodically updated and uploaded on the website. Etica’s active engagement approach, through dialoguing with Italian and foreign companies and voting at their AGMs, is committed to making companies more aware of their socio-environmental impacts and aims to obtain information about specific ESG topics.

Etica engages companies through different strategies:

- **Voting:** Etica votes directly at Italian companies AGMs and through an electronic voting platform at foreign ones. Etica involves foreign responsible investors through supporting their shareholder resolutions and asking them to join Etica actions with Italian companies;
- **Making speeches:** during all Italian companies’ AGMs, Etica makes a speech about their socio-environmental performance, underlining the points of weakness and improvement;
- **ESG information requesting:** Etica sends questionnaires to companies in order to obtain information about their ESG performance and to deepen any controversial issues.
- **Shareholders’ campaigns:** Etica joins shareholders’ campaigns promoted by international responsible investors’ networks, such as ICCR or PRI.

Shareholders’ campaigns: Etica joins shareholders’ campaigns promoted by international responsible investors’ networks, such as ICCR or PRI.

All Etica engagement activities are shared with an independent ethics committee, and are communicated externally both on its website as well as directly to clients and other stakeholders through newsletters, specific documents and periodical funds’ documentation.

1.3. Motivations for Engaging

1.3.1. Context

The rationale for engagement comes from classic principal-agent theory, which describes the need for investors (the principal) to ensure that company board and management (the agent) are acting in the best interests of shareholders. Investors monitor company behaviour through public disclosure and private dialogue. When public information is insufficient or company behaviour indicates that a change in behaviour is necessary, engagement is a powerful tool for investors.

More disconcerting than the potential positive power of engagement is also the frequent negative effects of ownerless companies. Robert Monks calls these drone companies, companies whose ownership is so diffuse that they essentially have no owners. These companies not only, on aggregate, “tend to pay their CEOs more and perform less well than their owned counterparts, they were also more likely to pay fines and settlements, to cut pension plans and pay no taxes.”^{vii}

Beyond the debate on the need for ownership oversight of corporations, however, a debate on the

purpose of companies is also raging. Traditional corporate governance theory argues that companies have a singular duty to maximise shareholder value, while modern stakeholder theory expands this to include other constituents.^{ix} This expanded view has, at times, been appropriated by: companies to thwart takeovers, unions to protect jobs, and NGOs to advance specific interests. Without expanding on this debate, it is worth keeping in mind that even the most responsible companies encounter challenges to balance all these interests in the face of growing stakeholder activism and focus on business conduct, rather than just profits.

1.3.2. Link with Risk Management and Value Creation

The motivations for engagement on ESG by investors thus stem from the oversight needed in order to ensure that supervisory board members and executive management are working in the best interests of shareholders (and other stakeholders). These interests generally fall into four categories that are not mutually exclusive:

- Reputational risks: Avoiding reputational risks and negative attention stemming from investing in companies that have or are revealed to have poor business practices or other issues from which investors would like to disassociate themselves.
- Maximising risk-adjusted returns: Investors seek to maximise returns and minimise risk. ESG issues have an impact on risk and return, and investors will engage on this in addition to strategy and performance, especially since ESG issues can have a significant financial or reputational impact, and disclosure is generally less forthcoming and standardised than is the case for financial information.
- Ethical considerations: Investors seek to avoid profiting from companies that are in conflict with the investor's moral/ethical beliefs or standards of conduct. Investors will use engagement to bring the company in line with these standards or beliefs in order to avoid excluding the company from the eligible universe of investments.
- Contributing to sustainable development: Investors recognise that improving environmental and social performance has an inherent benefit for society, especially in the long term. Doing so contributes to managing the long-term risk from issues such as climate change, biodiversity, inequality, obesity and unemployment.

There is thus a clear link to risk management and value creation in engaging with companies. As the concept of value creation and risk mitigation in investment has expanded over recent decades to include ESG matters (either as a driver of financial value or as an additional consideration alongside financial returns), it is no surprise that engagement on ESG matters is on the rise.

In fact, according to some sources, engagement is seen as one of the effective SRI strategies. For example, a survey by Oekom Research of 199 major global companies shows that 37.4% of respondents agreed that direct dialogue between the company and investors is the Responsible Investment strategy that has the greatest influence on the company's sustainability management.

^x In the survey, only Best-in-Class was rated higher at 39.9%, while Exclusions (negative screening) received 5.6%, and voting at general meetings 5.1%. While this may indicate that engagement is more effective in changing company behaviour than divestment, it is important to note that investors use different SRI strategies for different purposes. In addition, many investors use SRI strategies in combination with each other in order to enhance their effectiveness.

Topics for Engagement: Financial or Non-financial?

Historically, engagement by investors (asset managers and assets owners) has been focused on financial issues and strategy. In fact, an observation from companies at the forefront of sustainability risk management is that (financial) analysts never ask questions on ESG on-quarterly earnings calls.^{xi} Notwithstanding the observation that good companies in terms of ESG are less likely to be questioned on these issues, as equity analysts tend to focus on bad news rather than good, the quarterly call is typically not a venue for ESG Engagement. This is partly because most fund managers (just like most companies) separate the functions related to financials from sustainability. Some companies have added 'fifth analyst calls',^{xii} where sustainability matters are discussed with sustainability analysts, but for the most part, engagement on ESG is conducted in private. However, as interest in ESG issues has increased in the past decade, so has the prevalence of engagement on such issues, as seen in the figures published by Eurosif.

1.4. Catalysts for ESG Engagement

1.4.1. Universal Ownership and Long Term Investors

The financial crisis that started in 2008 has accelerated the focus on the impact of ownerless companies, as there are indications that many shareholders have forsaken prudent ownership and oversight in return for risky behaviour and the lure of quick profits. The importance of appropriate control of companies is especially evident for long-term investors, since they tend to retain ownership of corporations through several business cycles. This is also the case for large asset owners, such as sovereign wealth funds, pension funds and insurers, as many of them approach being universal owners,^{xiii} which are investors who have such broad portfolios that they own a minority share of most listed companies in the world.

Monks and Minow, in the context of pension funds as owners, characterise universal and permanent owners as follows:

"Their holdings are so diversified that they have the incentive to represent the ownership sector (and the economy) generally rather than any specific industries or companies. This endows them with a breadth of concern that naturally aligns with the public interest. For example, pension funds can be concerned with vocational education, pollution, and retraining, whereas an owner with a perspective limited to a particular company or industry would consider these to be unacceptable expenses because of competitiveness problems."^{xiv}

In this situation, it is difficult for an investor to move large parts of the portfolio or to outperform the market, so generally improving company practices becomes a strategy for managing ESG risk.

1.4.2. Fiduciary Duty

The concept of fiduciary duty is also influential in changing the behaviour of investors that manage assets for beneficiaries. The Freshfields report,^{xv} produced by the law firm Freshfields Bruckhaus Deringer in 2005 for the asset management stream of UNEPFI concluded:

"Conventional investment analysis focuses on value, in the sense of financial performance. As we

note above, the links between ESG factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.”

In the 2009 follow up to the report, Fiduciary II, ^{xvi} the report stated:

“Fiduciaries must recognise that integrating ESG issues into investment and ownership processes is part of responsible investment, and is necessary to managing risk and evaluating opportunities for long-term investment.”

For example, the UK Environment Agency Pension Fund states:

“Why do environmental issues such as resource scarcity, climate change and biodiversity matter, either to financial investors or to our pension fund? They matter because they affect all mankind and have significant implications for our financial returns. Such issues are described as being ‘financially material’.

Just to look after our current members, we will need to be able to pay retirement pensions well into the 21st century. Over such a long time frame, we expect future trends in global climate, population and economics to have a major effect on the financial value of our fund’s investments.

These issues also matter because we want our pensioners to live in a clean and healthy environment which is at least as good as the one we enjoy today. For many members, their pension will be their main source of income when they retire. We want them to have a happy retirement in a world where the environment is not deteriorating.” ^{xvii}

Furthermore, there are indications that shareholders themselves may increasingly be held accountable for the actions of the companies in which they invest. For example, two prominent European asset owners and their asset managers were named in a complaint filed in 2012 at the national Contact Points for OECD Guidelines for Multinational Enterprises in South Korea, the Netherlands and Norway. The complaint concerns alleged violations by South Korean company POSCO of the OECD Guidelines for Multinational Enterprises in connection with the company’s plans to develop iron mining operations, steel production and related infrastructure in India. ^{xviii} As minority shareholders it is unclear whether the OECD guidelines apply to the investors named, but the very act of being associated with a complaint can be damaging for investors.

While these developments do not give definitive legal certainty that integrating ESG issues into asset management and engaging companies is part of fiduciary duty, it nevertheless sends a strong signal to investors that managing assets on behalf of beneficiaries involves more than pure short-term profit seeking behaviour. This is especially the case when one considers the mounting evidence from academic studies and investor research that ESG issues are material to company performance. For example, there is evidence that strong company performance on ESG matters is positively correlated with financial performance indicators such as lower cost of capital. ^{xix}

Studies also indicate that asset trustees realise that ESG issues are important. For example, Euro-sif’s study of European Corporate Pension Funds and Responsible Investment from 2011 revealed that of the 169 pension funds responding to the survey, 111 (66%) agreed that having a policy on SRI is part of their fiduciary duty as trustees of funds for beneficiaries.^{xx} However, only 94 respondents (56%) stated that they had such a policy.

This mounting academic evidence, the UNEPFI reports, and other initiatives such as the Kay review of UK equity markets and long-term decision making,^{xxi} have led legislators in several jurisdictions to review whether the concept of fiduciary should be reassessed or at least clarified.^{xxii} The lack of clarity on fiduciary duty is also highlighted by some asset managers: “While the business case for sustainability is clear, some directors of companies and of investment funds continue to be unsure about whether sustainability is a fiduciary issue.”^{xxiii} Nicolodi also finds that “on a normative level, the experts agree with the statement that pension funds should influence corporations in the fiduciary interests of their beneficiaries both with regard to financial and non-financial issues”.^{xxiv} The need to clarify the concept of fiduciary duty is also one of the discussion points in the European Commission Green Paper on long-term financing of the European economy.

1.4.3. Stewardship Codes and EU Legislation

The increased attention on investors’ responsibility to be prudent and active owners has also triggered the development of soft-law initiatives on asset manager and asset owner disclosure. For example, the Stewardship Code in the UK, introduced in 2010 and managed by the Financial Reporting Council (FRC), sets out good practice on engagement with investee companies with the aim to “enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities.”^{xxv}

The principles of the UK Code state that in order to protect and enhance the value that accrues to the ultimate beneficiary, institutional investors should:

1. Publicly disclose their policy on how they will discharge their stewardship responsibilities;
2. Have a robust policy on managing conflicts of interest in relation to stewardship, which should be publicly disclosed;
3. Monitor their investee companies;
4. Establish clear guidelines on when and how they will escalate their stewardship activities;
5. Be willing to act collectively with other investors where appropriate;
6. Have a clear policy on voting and disclosure of voting activity;
7. Report periodically on their stewardship and voting activities.

Other national initiatives also exist, such as Eumedion’s ^{xxvi} Best Practices For Engaged Share Ownership, in the Netherlands. ^{xxvii}

At European level, the European Fund and Asset Management Association (EFAMA) has developed a ‘Code for external governance: Principles for the exercise of ownership rights in investee companies’. ^{xxviii} The code sets out six principles with best practice recommendations for engagement between asset managers and companies.

Furthermore, the International Corporate Governance Network (ICGN) offers a best practice document setting out the expectations that investors can have of their fund managers, and how they can formulate their contracts or mandates with those managers such that they deliver on client expectations, including on engagement.^{xxix}

The European Commission is also assessing shareholder stewardship and the need for legislative action at EU level. The European Commission’s Action Plan on Corporate Governance,^{xxx} released on December 12, 2012 outlines future initiatives in the areas of company law and corporate gover-

nance and covers three main areas:

Enhancing transparency – companies need to provide better information about their corporate governance to their investors and society at large. At the same time companies should be allowed to know who their shareholders are and institutional investors should be more transparent about their voting policies so that a more fruitful dialogue on corporate governance matters can take place.

Engaging shareholders – shareholders should be encouraged to engage more in corporate governance. They should be offered more possibilities to oversee remuneration policy and related party transactions, and shareholder cooperation to this end should be made easier. In addition, a limited number of obligations will need to be imposed on institutional investors, asset managers and proxy advisors to bring about effective engagement.

“Supporting companies’ growth and their competitiveness – there is a need to simplify cross-border operations of European businesses, particularly in the case of small and medium-sized companies.”

This Action Plan, which foresees a range of possible legislative outcomes including regulations, directives, recommendations and, where appropriate, no action is an example of the increased implementation of smart regulation in Europe which attempts to balance the need for intervention with the interests of all stakeholders.^{xxxi} Specifically, the Commission states in the Action Plan that it will in 2013 launch a legislative initiative on the disclosure of voting and engagement policies as well as voting records by institutional investors. Depending on the outcome of this process, having a public policy on engagement could therefore become mandatory in the EU.

All of these initiatives are examples of catalysts of ESG Engagement, serving to highlight the many sources of growth. Investors, beneficiaries, asset managers, legislators and other stakeholders are all seeing the value and need for more engaged shareholders.

Shareholder or Shareowner?

In this study, Eurosif uses the word shareholder to signify an investors’ ownership of economic interest in a company without implying that holding and owning shares have different connotations to the reader. However, some market actors do make a deliberate choice in the selection of terms. For example, the CFA Institute, in their publication “Shareowner Rights Across Markets”, uses the term ‘shareowner’ rather than the term ‘shareholder,’ deliberately because “share holding connotes a limited or passive engagement, comparable to the role of a custodian, whereas share owning connotes more active participation in exercising one’s rights.”^{xxxii} In general, Eurosif prefers to make the same distinction by referring to passive versus active owners. Passive owners do not practice shareholder stewardship or do so in limited capacity, preferring to benefit from the work of other investors. Active investors are constructively engaged with the companies they own.

Illustration 2: Rabobank Private Banking

The following example illustrates how one bank ensures that its fund managers comply with its Responsible Investment policy on behalf of beneficiaries.

For asset owners it is important that the engagement policy and their expectations of companies are integrated into the management of assets outsourced to asset managers. This will, in many cases, involve surveying asset managers on their adherence to the Responsible Investment policy of the asset owner, and incorporating asset owner expectations on engagement into the contractual or formal relationship with asset managers.

Rabobank Private Banking, part of the Dutch Rabobank Group, has explicitly formulated a Responsible Investment policy for its assets managed on behalf of beneficiaries. This has consequences for the investment procedures as well as the product offering.

For mutual funds, this means that next to the traditional qualitative and quantitative analyses, Rabobank also looks at how asset managers integrate responsible investing in their investment processes. This is also one of the criteria in the fund selection procedure. To gather the necessary information, Rabobank has developed a RFI (Request For Information) survey for asset managers. Among other things, the survey asks fund managers about ESG integration, voting and engagement policies, and exclusion policies.

In particular, the bank is interested in the following aspects of the investment policy of each fund supplier:

- Has the asset manager in question signed the Principles for Responsible Investment?
- Does the asset manager have an exclusion policy with respect to controversial weapons?
- Are the UN Global Compact principles integrated in the investment process?

This can be achieved in different ways, e.g. by explicitly integrating non-financial, ESG-criteria in the investment decisions or by engaging with portfolio companies that are not fully compliant with the GC-principles.

Rabobank shares this information with its client relationship managers and clients in order to enable informed decision-making. For this, they use a customized version of the Morningstar Fund Selector.

The goal is to have a fund range on its platform that is completely in line with the RI criteria. In cases where the mutual funds were not yet in line with (all) the requirements, Rabobank started a dialogue asking asset managers to move in the desired direction. Eventually, all of the fund managers have to meet the three RI criteria. New suppliers have to do so from the start of the offering. As a result of engagement efforts, currently 95% of all mutual funds on the Rabobank Private Banking platform meet their Responsible Investment criteria.

The feedback from clients of Rabobank Private Banking indicates that they are positively surprised by the systematic way in which it engages with the asset managers and the results achieved. In addition, feedback from asset managers suggests that, in many cases, the process provided a positive stimulus that brought about change within the organization of the asset manager.

SECTION 2

THE FIVE PHASES OF ENGAGEMENT

2.1. Introducing the Five Phases

The typical engagement process consists of five phases. The five phases of engagement cover the process from start to finish:

- **Define:** Producing a policy on engagement, including the aims and topics for engagement;
- **Monitor:** Observing portfolio companies to identify companies at risk, and selecting targets for engagement;
- **Act:** Deciding on achievable objectives from engagement and an actionable strategy for engagement with each target. Initiate strategy;
- **React:** Evaluating the outcomes of first engagement and assessing the need for escalating the activity or adjusting the strategy;
- **Communicate:** Measuring the impact and value creation from engagement and communicating outcome to beneficiaries and other stakeholders.

Though these phases are presented as distinct, they are continuous and often overlap. The division between the phases therefore are less distinct than the simplified illustration suggests.



Figure 3: The Five Phases of Engagement (Source: Eurosif, 2013).

This framework can be applied to any form of engagement, but in this report it will be applied specifically to ESG Engagement.

The process beginning with communicating expectations through to realising a successful (or unsuccessful) outcome can take time - even months or years. ESG engagement, as covered by this study, is therefore a strategy that is particularly well suited to investors who manage investments for the long-term, although is not restricted to long-term investors.^{xxxiii}

Illustration 3: Ethical Council of Swedish AP Funds 1-4

This example provides a high-level view of the organisation and systematic process used by four asset owners to collaborate on engagement.

The four Swedish AP Funds that are collective members of the Ethical Council invest globally in diversified portfolios comprising several thousand companies. A large proportion of the assets of the funds are passively managed, which means that the funds have a wide spread of ownership, with relatively small stakes in a range of companies. The Ethical Council does not

have sufficient resources for active management in all of the holdings, and Council therefore applies a systematic process for identifying where active management will reap the greatest benefit. The process helps to ensure a good spread of issues, geographical locations and assets, so that not all of work is derived from the same industry or relates to the same issues.

The working method of the Ethical Council is based on monitoring the portfolios of the four AP Funds for violations of international conventions. The goal of the Ethical Council is to conduct a dialogue with companies that can be connected to breaches of conventions signed by the Swedish State, with a view to driving them to take action. The examination is carried out with the help of an external consultant who, on a daily basis, seeks out and gathers relevant information from a large number of sources, including various UN sources, the media, and reports from a range of voluntary and stakeholder organisations. The shareholdings of the AP Funds are matched against this database, and in cases of reported incidents involving violations of international conventions, these companies are further investigated.

The figure below shows the steps of this systematic process, including the two possible outcomes of either achieving the objective of engagement or not achieving the objective and recommending a sale.

	Consultant	Ethical Council
STEP 1 Examination of the holdings of the Funds	Systematic monitoring of information on approx. 4,200 companies. Sources include media, stakeholder organisations and UN bodies	The Ethical Council becomes aware that an incident has occurred in one of its portfolio companies.
STEP 2 Closer investigation	Around 100-200 companies are investigated more closely, based on reports of alleged violations of international conventions.	
STEP 3 Choice of dialogue company	Dialogues are also maintained with the companies (under step 2) with the Ethical Council has chosen not to enter in direct dialogue, but where suspected or confirmed violations of international conventions exists. The dialogues with these companies are carried out by the consultant, on behalf of the Ethical Council and other clients.	The Ethical Council takes the initiative to start direct dialogues with 10-15 companies where problems are significant, well documented and where the Ethical Council can make a difference through its engagement
STEP 4 Dialogue work		Additional pressure is applied. This includes cooperation with other investors, plus filing resolutions and voting at AGMS.
STEP 5A The objective of the dialogue is achieved	Special monitoring of the company for 5 years.	If the first four steps achieve the desired result, the company is removed from the Ethical Council dialogue list.
STEP 5B Sale recommended		If the first four steps do not produce the desired results, each individual Fund makes a decision on the possible sale of its holding based on a recommendation from the Ethical Council. The Ethical Council then contacts the above companies once a year to check whether the situation has changed and to urge the company to operate in line with.

Figure 4: Ethical Council Systematic Process (Source: Ethical Council of AP Funds 1-4).

2.2. Phase 1: Define and Communicate an Engagement Policy

The first phase of engagement starts with the asset manager or asset owner defining and compiling an engagement policy. The policy should be aligned with the overall investment philosophy and beliefs of the investor and may include the following elements:

- The rationale and purpose of engagement;
- The methods available to the investor;
- The resources dedicated to engagement;
- The assets or asset classes covered by the engagement policy;
- The organisational structure responsible for engagement;
- The use of collaborative initiatives;
- The communication to stakeholders of engagements.

The input for the investor engagement policy and the general Responsible Investment policy can come from many sources. Best practice frameworks such as the PRI's six principles or the Ceres Blueprint for Sustainable Investing can be used as models. Ceres, for example, lists 10 steps towards sustainable investing, including engagement and voting.^{xxxiv} Other examples of national or international best practice documents that can provide guidance for investors also exist such as shareholder codes of conduct, and it is important for investors to identify the ones that are most relevant for their individual aims, context and legislative environment.

For example, corporate pension funds may find guidance from the funding company's own policies on business conduct. According to the Eurosif study on "Corporate Pension Funds and Sustainable Investment", respondents often used the CSR policy of the funding company as input to the SRI policy of the fund, or received input from members for the policy.

The responsible investment or engagement policy should be disclosed to the public, or at least to the fund beneficiaries as part of the regular reporting. For example, SNS Asset Management's policy includes clear disclosure of their aims on their website:^{xxxv}

"The environmental, social and governance issues that lead to engagement emerge from our Fundamental Investment Principles (FIP). Engagement can take two forms: responsive or pro-active. With responsive engagement, the objective is to prevent SNS AM from being forced – based on its FIP – to exclude a company from investment. Exclusion could be necessary if controversies prove very serious, while remedial measures and/or the willingness to prevent controversies from happening in the future, seem too limited. Understanding the company's response to a controversy is therefore a pivotal step in the engagement process. With pro-active engagement, SNS AM discusses with companies, before a controversy occurs, how policies and performances on ESG matters could be strengthened. In both cases, responsive and pro-active, SNS AM can opt to either approach a company alone, or to cooperate with other investors. Cooperation tends to prove preferable, as it renders the dialogue more efficient for the company – and thus often more fruitful – and can lead to more leverage in soliciting change."

The engagement policy can cover the entire asset base of the investor, but can also be applied at the level of individual funds or mandates. At fund level, the European SRI Transparency Code, launched in 2004 and developed and maintained by Eurosif, provides a standardised format for disclosure of Responsible Investment practices by fund managers to the public, in particular retail investors.

The Code requires signatories to disclose whether the fund has a specific ESG Engagement policy and a voting policy covering ESG issues.

Novethic Engagement Award

Novethic is a prominent French research and media centre focused on CSR and SRI. It awards an SRI Label each year to qualifying retail funds, after a rigorous assessment, to provide individual investors with a framework for SRI products offered by investment managers.^{xxxvii} The framework incorporates the European SRI Transparency Code. In addition to the Novethic SRI Label, funds could obtain, from 2009 to 2012, special awards, including the Engagement Award. To obtain the Novethic SRI Label's Engagement Award, candidates had to demonstrate that they had implemented a successful approach and communicate with third parties. These criteria are crucial because demonstrating the impact of engagement campaigns also helps legitimise them in the eyes of decision-makers, notably institutional investors. Novethic has decided in 2013 to suspend the Engagement award, as engagement actions are usually done in the name of the asset manager as a whole and not for only one SRI funds and also due to the few existing applications for this award.[^]

For 2012, 109 funds were awarded the label, four of which were also awarded the Engagement Award. One of these is the Guilé European Engagement Fund,^{xxxix} which is managed by de Pury Pictet Turrettini & Cie S.A. (PPT), an independent Swiss company founded in 1996.

The Guilé fund is part of a family of Guilé Engagement funds whose activism is based on the exercise of voting rights, as well as on an on-going and sustained dialogue with the companies held in portfolio. The fund normally holds a concentrated portfolio of 30-50 European companies, and engages with all of them. The fund selects investments in companies rather than focusing on issues and as a general rule, the companies in the fund portfolio are held for 5 to 10 years.

Adherence to the principles of the United Nations Global Compact (UNGC) is at the core of the engagement approach, and according to the fund, a company can be transformed under the influence of its investors under certain conditions:

- If it is studied in light of the economic realities in its specific field;
- If the analysis is performed according to a universally recognised framework such as the United Nations Global Compact rather than according to a 'personalised' viewpoint;
- If the targeted improvements result in better ESG (Environmental, Social and Governance) risk management while enabling it to seize the opportunity for a competitive advantage as a result of this trend.

The engagement is performed by the Guilé Foundation, which receives a significant portion of the fund management fees. The foundation has signed a memorandum of understanding with the UN Global Compact office, giving it the role of catalyst in helping the companies implement and report on the ten principles of the UNGC. Transparency is maintained by explaining and illustrating the impact of the shareholder engagement in the funds Annual Engagement Report or on the asset manager website.

In addition to having a general engagement policy available to the public, it is also best practice to develop a set of expectations that the investor can communicate along with the engagement policy to its portfolio of companies. These can be general in nature, for example that the investor expects

all portfolio companies to abide by international principles of business conduct such as the UNGC or the OECD Guidelines for Multinational Corporations. They can also be more specific, in cases where the investor has certain focus areas. For example, NBIM, which manages the Norwegian Pension Fund (Global), has set out specific expectations on children's rights, climate change risk management and water management, which the investor uses as a basis for dialogue with companies.^{xl} For the latter, NBIM expects companies to have:^{xlii}

"A clear water-management strategy

Investors should be able to assess how water scarcity may impact a company's operations and financial results. Companies should evaluate the extent to which water is an input and output factor in production processes. (Analysing their exposure to and dependency on water in their operations and supply chains).

Sustainable water management

Companies in industries that are particularly exposed to water-related risk and regions that have the best systems and technologies to deal with water challenges are better positioned to mitigate water-related risk, identify new market opportunities and create shareholder value. A company's water use may impact its surrounding community. Sustainable water management should take measures to mitigate adverse effects on local communities.

A governance structure

Companies must have a corporate governance structure that facilitates realistic strategies and responses to water management. The following elements should be considered: board-level involvement, board committee structures, management responsibilities, risk management and internal control processes, reporting lines, timelines and clear targets."

Complementing general expectations (such as the UNGC) with specific ones on issues of particular interest is a good way to define the focus of the engagement policy, and being specific helps to better measure engagement activities.

In summary, the first phase of the engagement process thus concerns the establishment of an engagement policy, including purpose and aim, and the communication of this policy to companies and beneficiaries. This phase can be characterised as involving both internal and external resources, and is periodical in the sense that policy and expectations should be reassessed regularly (for example annually).

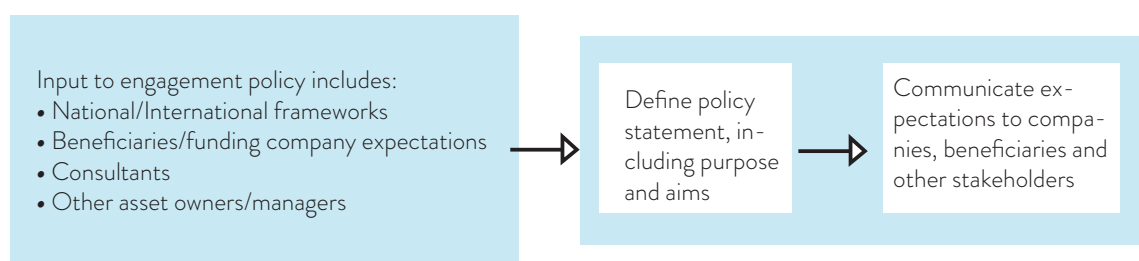


Figure 5: The First Phase of Engagement (Source: Eurosif, 2013).

Illustration 4: Mirova

This case study illustrates how engagement initiated by financial risk highlighted deficiencies in corporate governance structure of a company.

In 2011, a large cap food retailer announced the spin-off of its hard discount division and a partial split of its real estate. Both operations would eventually lead to the distribution of an extraordinary dividend to shareholders on July 2011. The implementation of these two decisions depended on the approval of two thirds of voting shareholders at the Extraordinary General Meeting of June 2011.

Mirova's analysis of the proposals raised questions about the interest of the spin-offs from a strategic point of view and the potential of the two decisions creating value in the long-term.

The biggest concern was the spin-off of the real estate. While it would be very attractive financially in the short term, the spin-off offered risks for the development of retail activity in the long term. Mirova believed that the loss of control of its property could deprive the group of the flexibility in the control of rent and reduce its ability to participate in price competition in a sustainable way due to increased fixed cost.

In addition, the announcement highlighted serious problems of governance that Mirova had previously identified during their ESG analysis process. In fact, all the decisions were taken and controlled by its major shareholders, even though they did not control the company in economic terms. Additionally, the board had set up a strategic committee made up of majority shareholders and management, which held discussions behind closed doors. Moreover, the composition of the board suffered from a lack of members with specific skills and experience in retail sector, which weakened its ability to challenge the strategic options proposed by the main shareholders along with the management.

Given this situation, Mirova decided to engage with the company to discuss the rationale of the spin off and ask for improvements in the board's decision process in order to ensure that the long term interest of the company was taken into consideration and that minority shareholders rights were upheld.

Thus, Mirova initiated dialogue with different company representatives:

- The CEO and CFO of the group: They discussed the rationale behind the strategic decision and also learned about the decision process within the board that led to such conclusion.
- The chairman of the board: Mirova went into the detail of the governance structure to understand the interaction between the executive committee, the board and the main shareholders. Mirova better understood the nature of the strategic committee that had been put in place and recommended that it be replaced by an open discussion with all members of board in order to uphold good governance practices.
- The representatives of the two main shareholders (both members of the board): Mirova discussed in detail the motivations and potential consequences of the strategic decision, and the what, where and how of aligning majority and minority shareholders' long-term interests.

- This dialogue helped Mirova to better understand the company's governance system and allowed them to identify ways to improve it. Thereby, Mirova asked the chairman of the board to dissolve the strategic committee and introduce more independent directors with specific skills in retail sector. Mirova also strongly encouraged the company to reconsider its decision to spin-off its real estate.

The company responded positively to Mirova's expectations and reorganised its governance system. The strategic committee was dissolved and new independent members with a long-term experience in the retail sector have joined the board in the year since the dialogue. Furthermore, the spin off project was finally abandoned as per decision taken by the full board.

2.3. Phase 2: Monitoring Portfolio Companies and Selecting Targets

The second phase in the engagement process is to monitor the portfolio to identify potential targets for engagement. A wide range of criteria exist for this:

- ESG screen/score: Companies within the portfolio that exhibit very low ESG absolute or relative scores or the lowest ranked will be selected for further analysis, which may lead to engagement.
- Largest holdings: Since the largest companies in relative terms represent the biggest risk to portfolio performance, many asset managers will focus on their biggest holdings for engagement.
- Local market: Engaging primarily on the local/domestic market is common in the beginning of implementing an engagement strategy. This is also a convenient place to start, since domestic holdings tend to be a dominant part of the portfolio, the asset manager is more familiar with the market specificities, and there are no language barriers.
- Sector/market specific: Methodology which focuses attention on certain industries or markets seen as high-risk in terms of ESG, such as extractive industries, or emerging markets.
- Value at risk: Identifying the companies in the portfolio that have the most financial value at risk from ESG concerns.
- Ad hoc controversies: Where information in the media or revelations by NGOs highlights certain risks associated with a company, industry or market. In this case, the asset manager will engage on specific issues after risks have been revealed.

An asset manager can use one or several of these criteria in combination to identify and select companies for further analysis in the engagement process. As seen in the SNS case above, engagement can also be pro-active in order to identify and mitigate risks before they become material and it can be responsive in cases where a controversy has been exposed to the market.

Once a company has been selected for further analysis, an assessment of the issues facing the company, the risks to the investment, and the potential remedies to mitigate the risks is performed. The nature and intensity of this assessment depends on the nature of the issue and the resources of the organisation. In some cases, the investor will publicly announce the companies being assessed for engagement in the form of a watch list. However, in most cases this list is not public.

As ESG concerns identified for the purpose of engagement are often also connected to the financial risk/return profile of the company, the engagement effort will involve a financial analysis as well as a non-financial analysis. For example, CalPERS, a leading US asset owner, develops a focus list each year based on financial and ESG performance, and seeks to meet with each selected focus list

company to better understand their governance structure and business strategy before potentially taking action.^{xliii}

Verifying the potential risks to the valuation of a company from ESG concerns and building a case for change are crucial steps in the preparatory work for potential engagements. Without a well-reasoned business case to present to the company, it will be very difficult to generate change. Some investors also use their network or other informal structures to see if other shareholders have seen or analysed the specific company issue. This sharing of knowledge can be useful in cases where the investor may be looking for additional support, and where the investor is not expecting a short-term price movement resulting from the engagement, so there is no strategic advantage to having identified a potential ESG issue.

The analysis can lead to two outcomes: either the investor will find that the issue is not worth pursuing because, for example, it is not financially material, in which case the engagement process stops before contacting the company; or the investor will decide to proceed with the process of encouraging change. Since engagement can be resource intensive and time consuming, it is not unusual for even large asset managers to focus activity on less than 200 companies. This may constitute a small portion of the portfolio, so it is important to focus attention where it can have the most impact in terms of protecting value, improving ESG performance and mitigating risk. This balance between limited resources and maximising impact is also the reason why many investors will collaborate on engagement, as this pooling of resources and economic stakes increases the efficiency of engagement. This is discussed further below.

In summary, the second phase of the engagement process thus entails monitoring the portfolio for potential targets for engagement, and analysing the identified companies. This phase can be characterised as involving mainly internal resources, and is continuous in the sense that monitoring is an on-going effort:



Figure 6: The Second Phase of Engagement (Source: Eurosif, 2013).

Illustration 5: GES

The following case study illustrates how a consultant uses an ESG risk rating to identify emerging market companies for engagement.

GES is a provider of global engagement services to asset owners and asset managers.

Rating ESG risks

A study based on GES Risk Rating methodology shows that the uncovered ESG risks are about twice as large on emerging markets (EM) compared to developed markets (DM). In order to address the risk and opportunity lying in the elevated ESG risks on EM, GES developed an engagement service specifically designed to narrow the gap between ESG risks and ESG preparedness and performance.

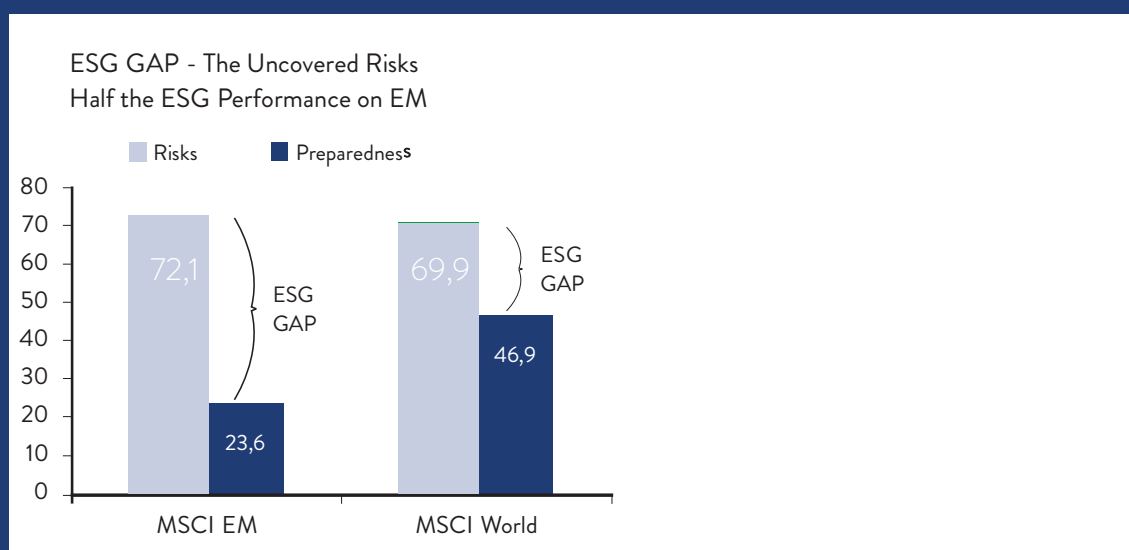


Figure 7: ESG GAP – The Uncovered Risks (Source: GES Risk Rating, 2012).

The GES Emerging Market Engagement takes a point of departure in the investor clients' EM portfolio and:

- Performs a risk rating in order to identify the gap between the ESG risks and ESG preparedness and performance;
- Screens for violations of international norms and conventions;
- Selects for engagement the companies violating international norms and conventions and those companies with the largest ESG Gap.

Engagement process

The engagement process starts out by building a common understanding of the most material ESG risks and opportunities that the specific company faces. GES stresses the value of also looking at the ESG opportunities and providing feedback and input from an integrated business and ESG perspective. The best engagement results are achieved when the engagement manager can provide actionable recommendations for improvement with tangible business results.

The engagement process is organised to ensure onsite meetings at least once a year on all major emerging markets – Mexico, Brazil, South Africa, Nigeria, the Gulf, Russia, India, Hong Kong, Korea, Mainland China and South East Asia. Engaging on EM is much about building

trust and awareness, and it is crucial for the engagement results to invest in meeting people face-to-face early in the process. In between the annual onsite meetings, GES engagement managers conduct a conference call to follow up on progress and keep in contact every six months. Currently, GES engages with more than 120 companies on emerging markets.

From every meeting and conference call, the GES engagement manager produces draft meeting minutes combined with risk rating scores, screening results, and recommendations regarding opportunities for improvement. The company is given the opportunity to review the minutes before it is uploaded to the web-based GES Engagement Forum, where it is available for the investor clients, along with all the research and previous engagement information on the specific company.

If necessary, which rarely is the case, the GES engagement manager can also apply a wider range of engagement tools, like investor signed letters to the CEO and/or the board, PRI Clearinghouse, proxy voting, and so forth.

There are significant regional differences in the company response to the engagement. Africa (excluding South Africa) and the Middle East have been the most challenging regions in which to engage, but persistence and the possibility to meet face-to-face on the company premises have been the key to open relationships. It can be challenging to establish contact with Chinese companies too, but using Chinese-speakers to establish the first contact and assist in the engagement process makes a big difference. In many cases, companies share that GES is the first investor representative with whom they meet in person for a dedicated and focused discussion on ESG and sustainability.

Example

For the past two years, GES has engaged with a large regional telecommunication company that has operations in various high-risk countries. Telecom often falls ‘below the radar’ in ESG driven engagement, because these companies generally have relatively lower ESG risks. However, this company has significant human rights related risks (data security and integrity) with regards to its operations in high-risk countries. Based on the engagement with the company, the issue was quickly raised at the board level, where an ethics committee was established to develop a group-wide human rights policy with an adequate management and reporting system. The issue was specifically addressed by the CEO/President’s statement in the recent sustainability report and the company is well on the way of mitigating the risk in a credible way.

2.4. Phase 3: Define Objectives and Initiate Engagement Strategy

The third phase of the engagement process is to act on the information identified and analysed in the second phase. This typically involves setting the objective of the engagement so as to be clear on the desired result(s). It may also involve setting intermediate milestones to track the progression towards a potentially successful outcome. At this stage, the investor will also define success criteria and a timeline.

There are a number of options open to investors for engagement with a company:

- Private direct communication: This can involve writing a letter to the company, phone calls or

face-to-face meetings. While the latter may be the most effective, it is also the most difficult to achieve. Some companies are happy to meet their investors to talk about ESG issues, while others are not. An additional challenge is gaining access to the correct person, both in terms of expertise and decision-making capability. For example, investors will often try to meet with senior management or the board rather than CSR or sustainability managers in order to better communicate the business case for sustainability.

- Collaborative engagement: This involves working with other investors on an informal basis, or on collaborative platforms. By being supported by a higher proportion of company share capital, the likelihood of success of engagement is improved. Section 3.2 provides more details on collaborative engagement.
- Public direct engagement: This involves making the engagement or intent to engage public knowledge through investor communication, the press or other means of transparency. It can be a more activist style of engagement, using media channels or NGO networks to create a reputational risk for the company. However, public engagement also occurs in other fora such as at AGMs or on investor calls and road shows.
- Exercising voting rights: Investors also use their right to vote shares at general meetings of shareholders (AGMs or EGMs) to influence company behaviour. Often the threat of a negative vote at an AGM can be a powerful incentive for companies to engage with their owners.

Investors may use one or several options at any given phase of the engagement. According to data collected by Eurosif for the “European SRI Study 2012,”^{xliii} beyond voting shares the most common form of ESG Engagement is single institutional investors engaging target companies directly in private. Figure 8 shows that 39% of respondents conduct engagement with portfolio companies on ESG matters in private. The second most common form of ESG Engagement is to engage with a company in collaboration with other investors, either in public or privately. Less common is the engagement of industry groups and policy makers, and individual investors engaging companies publicly.

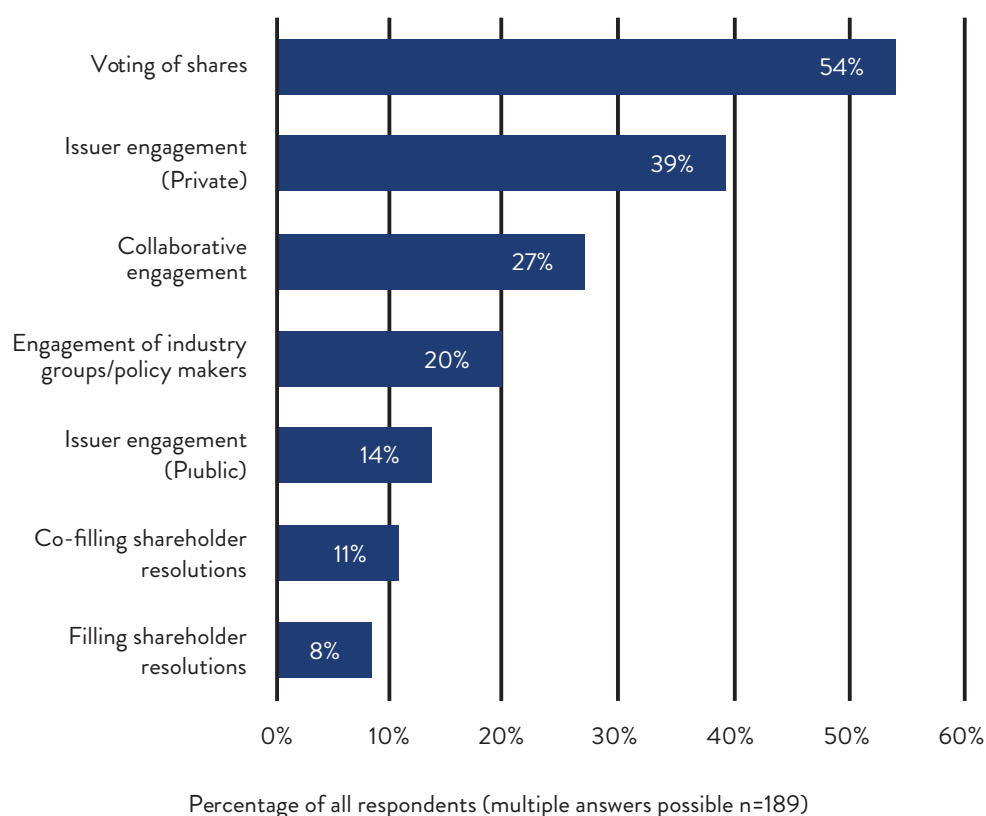


Figure 8: Investors' Use of Engagement Strategies (Source: Eurosif, 2013).

The data also indicates that investors that engage typically select between 100 and 200 companies for engagement annually. However, there is considerable variance in the data ranging from just a few to over 1,000 companies. The number of companies engaged with in relation to total portfolio holdings will also typically be small. For example, large diversified investors can hold close to 10,000 companies in their portfolio, in which case 200 is a small number. However, some investors will have ‘focus portfolios’ consisting of a much smaller number of companies, and actively engage with these. In a handful of cases, the fund manager will engage on ESG issues with all companies held.

This range of engagement, from just a small proportion of the portfolio to covering all companies, reflects the cost-benefit compromise that especially large investors undertake. At the same time, quantity is not an indication of quality or impact, as the intensity of each engagement can vary from sending a letter to the company to very deep and protracted engagement. Thus, focusing on getting just a few engagements right, rather than trying to cover a large part of the portfolio may be a smart strategy for certain investors.

At the bottom of the list we find the filing of shareholder resolutions at company AGMs (or co-filing with other investors). This is not as common in Europe as it is, for example, in the United States or Canada. According to the “GSIA Sustainable Investment Review 2012,” there is a big difference in the use of shareholder proposals in Europe and the United States, not just on ESG matters. While these proposals are a common vehicle for change in the United States, ^{xliv} accounting for several thousand proposals each year, there are typically less than 10 of these each year in Europe. Most shareholder proposals relate to governance issues, but specifically on environmental and social matters, there were 358 proposals in the United States in 2012 according to statistics from Institutional Shareholder Services (ISS), with 170 making it to a vote at the AGM. The lack of shareholder proposals at European AGMs is not necessarily due to technical barriers, as the requirements for filing shareholder resolutions have lower thresholds in many EU member states than in the US (the classic example being the Nordic countries where one share is sufficient). Rather, the differences are mainly cultural and historical: European investors vote shares, but the main vehicle for change is private engagement rather than proposing a shareholder resolution on an ESG issue. In the US, the mere filing of a shareholder resolution can actually be a vehicle for successful engagement, as many proposals are withdrawn before the vote because companies respond to investor demands.

The type or range of methods used should be tailored to each case, and depends on the resources available, the characteristics of the company (type, size, industry, location), and the nature and severity of the issue. Success criteria also need to be defined based on the aim and nature of the engagement activity. For example, if the aim of the engagement is to improve disclosure on risks from climate change, then success is defined as achieving the relevant disclosure. If the aim is to improve the health and safety of workers in the supply-chain, then success is defined as achieving improvement on health and safety indicators or reaching a certain level of health and safety for workers. If the aim is to separate the function of board chairperson and company CEO, then success is defined and achieved when these functions are separated.

In many cases, the achievement of success will take months or years of engagement, and it is therefore important to set milestones on the path to success. For example, engagement on a specific controversy with a large company can involve milestones such as arranging a company site visit to assess the nature of the controversy in order to better understand possible actions open to the company. It is however important to remember that the best engagement results are achieved when the engagement manager can provide actionable recommendations for improvement with tangible business results.

In summary, the third phase of the engagement process thus concerns setting success criteria and milestones for engagement and selecting the method(s) for engagement, possibly including other investors. This phase can be characterised as involving internal and external resources, and is continuous in the sense that the process is on-going.



Figure 9: The Third Phase of Engagement (Source: Eurosif, 2013).

Illustration 6: RobecoSAM

This case study illustrates the value of on-site visits in order to assess ESG risks.

Following the blowout on the Deepwater Horizon on 20 April 2010, RobecoSAM started a 3-year engagement with BP as the blowout was defined as a structural breach of the UN Global Compact principles incorporated into RobecoSAM's investment management. As part of the engagement, RobecoSAM recently went to Houston to see how BP manages risk in wells.

One response of BP to the disaster was the set-up of a Monitoring Centre in Houston (HMC), where all Gulf of Mexico operations can be monitored. The centre allows remote monitoring of real-time data, and surface and subsurface video control of the drilling operations. In the worst-case scenario of a blowout, BP has access to its own capping stack in addition to industry-shared equipment around the globe, aimed to stop any leak at a BP well in the world in less than 10 days.

RobecoSAM considers that the engagement with BP on this particular issue is progressing favourably and can soon be closed effectively as BP is making good progress on implementing the 26 recommendations of a report aimed at preventing another blowout. BP's safety standards are now better aligned with the risk exposure which, together with the company's general streamlining, reduces the risk of its deepwater activities.

The relevance for investors such as RobecoSAM is that by taking the situation at BP as a base line, it knows better which questions to ask other companies active in deepwater drilling. This will help investors to identify the companies that are most advanced in risk control, and find early warning signs of operational risks.

2.5. Phase 4: Evaluating Outcome and Need for Escalation

The fourth phase of the engagement process involves measuring and evaluating the progress towards a successful outcome and determining the need for adjusting the action or escalating the

intensity. Although it is obviously preferable to encounter little resistance in the engagement process, investors often do encounter obstacles in their engagement with companies. The menu of engagement tactics is not different from those in the third phase, but it may be necessary to adapt the weapon of choice.

Measuring the progress of the engagement effort and selecting the right time and method for escalating the engagement is more of an art than a science. Many investors will track the progress in spreadsheets with defined milestones and timelines. For example, if the company has not responded to a letter or an email after one month, a telephone call to request a meeting may be necessary.

However, it is also good practice to give the company sufficient time to respond to the issue and set realistic deadlines for company actions. Large companies especially move slowly, and getting the issue to the right person can be a slow process internally in the company. Additionally, if the issue is to be raised at board level, the engager must also take into account that many boards meet less than once a month with agendas that are often set weeks in advance. For instance, the full board of Shell met eight times in 2012, so getting an issue on the agenda of the board can take time.

Companies may also have internal barriers that frustrate the engagement process. For example, “[a]t one continental European industrial company, the IR officer insisted that a major institutional shareholder meet him first, even though the investor was seeking personal assurances from the CEO that remedial measures undertaken in response to the findings of an internal investigation were progressing well. This lack of access to the CEO contributed to the decision by the institutional shareholder not to support the discharge of the board at the AGM.”^{xlv}

Another tactic could be to submit a shareholder proposal at the company’s annual general meeting (AGM). This is, however, sometimes viewed as a last step in the engagement process that is used if all other avenues for dialogue have failed. Particularly in Europe, shareholder resolutions on ESG matters are rare, although they are used more regularly in US companies (both by local and foreign investors). Differing legal frameworks can, however, act as a barrier to submitting shareholder proposals especially across borders.^{xlvi}

In many cases, it can be effective to build coalitions with other investors and engage as a group, if the concerns raised by one investor are relevant to others. This type of collaboration can be formal or informal, and not only increases the probability of success, but can also reduce cost by spreading the time and expense on several investors.

In the event that numerous engagement efforts and collaborative engagement is not successful, the investor must decide whether to continue to pursue the case. In general, there are three choices for investors:

- Continue engaging with the company. This is especially relevant for investors who do not have the mandate to divest from a company due to ESG issues, as is the case with many index investors.
- Reduce exposure to the company. Investors may consider reducing their stake in the company in order to reduce the perceived risk from the issue under engagement.
- Divest the company from portfolio. Investors will sometimes remove a company from its investible universe due to an ESG issue, either because of the reputational or financial risk involved.

According to data collected by Eurosif for the “European SRI Study 2012,” European investors

that exclude companies will screen out between 1 and 60 companies from their portfolios. Some investors will publish their list of excluded companies along with the reason for exclusion; although far from all investors do this. It is considered best practice to at least inform the company that it has been excluded from the portfolio, as well as offer a justification.

Fund managers in general try to avoid excluding many companies in order to limit the increased diversification risk. Portfolio theory holds that restricting the investment universe can increase risk or reduce performance, but in practice the impact on performance and risk from excluding a few companies from a large portfolio is likely to be limited (even if passive investors may pay extra attention to the impact of exclusions on the tracking error than active investors). For example KLP, a Norwegian index investor, measures the effect on portfolio return from excluding companies. Over the period 2003-12, the annual deviation from the neutral equity index has ranged from -0.82% to +1.00% with an annual (arithmetic) average of -0.06%. KLP reweights their index to be industry neutral, and most of the deviation is from excluding tobacco companies. According to KLP, there has been no measurable deviation from the index on the bond portfolio. ^{xlvii}

Voice or Exit?

On page one of *Exit, Voice, and Loyalty* (1970), Albert O. Hirschman writes:

“Under any economic, social, or political system, individuals, business firms, and organizations in general are subject to lapses from efficient, rational, law-abiding, virtuous, or otherwise functional behavior. No matter how well a society’s basic institutions are devised, failures of some actors to live up to the behavior which is expected of them is bound to occur, if only for all kinds of accidental reasons. Each society learns to live with a certain amount of such dysfunctional or mis-behavior; but lest the misbehavior feed on itself and lead to general decay, society must be able to marshal from within itself forces which will make as many of the faltering actors as possible revert to the behavior required for its proper functioning.” ^{xlviii}

In the context of this study, a misbehaving company is one identified by investors as breaching standards of business conduct, taking excessive risks or in other ways warranting attention due to ESG factors. The question faced by the investor is: Exit or Voice?

As seen in this study, the choice depends on a number of factors, including the internal policies of the investor, the nature of the misbehaviour, and whether voice has already been met with deaf ears.

While exit may appear to be throwing in the towel, it can also promote dialogue and change. According to Louche and Lydenberg, there are two conditions that are necessary for divestment to have practical effects: the company must be aware of the action and the reasons behind it, and the action must negatively affect the company’s reputation or valuation. ^{xlix} Novethic suggests that while divestment itself cannot change a company’s behaviour, “it gives substance to the concept of risk [from ESG factors].” ⁱ

In summary, the fourth phase of the engagement process is the time for investors to react to the company’s response from the first engagement. In the event the first engagement effort is successful, this can be a short phase, consisting of reconciling the outcome with initial aims. This can

lead to further engagement (escalation) either in collaboration with other investors or not. It can lead to shareholder proposals to the company, or ultimately to exclusion of the company from the investible universe.

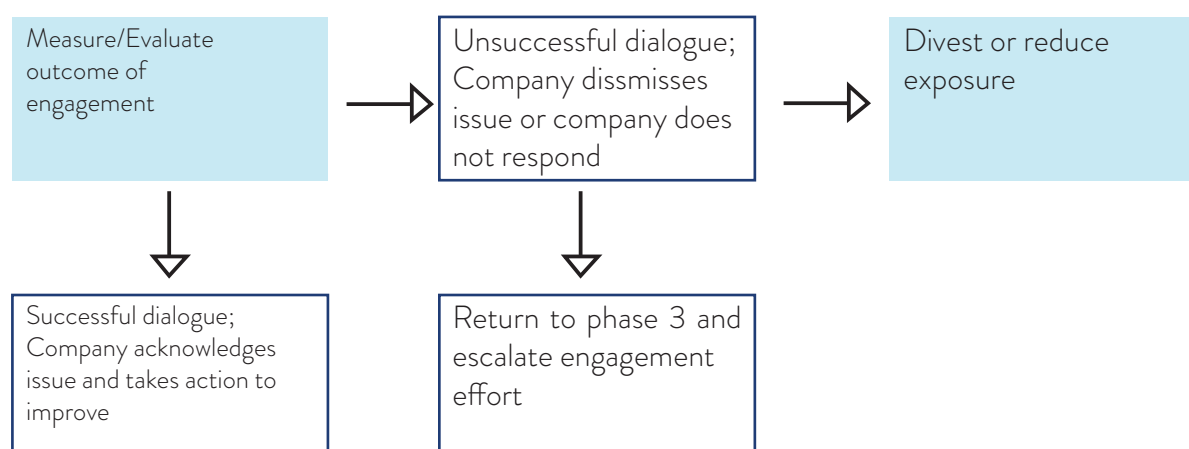


Figure 10: The Fourth Phase of Engagement (Source: Eurosif, 2013).

Illustration 7: ASN Bank

The following case study illustrates how engagement can also be used to change practices at companies before investing.

ASN Bank has a responsible investment policy that prohibits that bank from investing in companies involved in the weapons industry. Philips, a large Dutch engineering and electronics company, was seen as a potential investment for the bank. However, any investment was made impossible by the 20% stake Philips had in Dutch Aero, a company active in the defence industry.

Although not a shareholder, ASN Bank engaged with Philips and raised the issue of Dutch Aero, stating that they would like to invest in Philips but only if Philips divested from Dutch Aero. The issue was also raised several times at the company AGM through the VBDO, the Dutch Sustainable Investment Forum. Finally, in April 2013, after the VBDO raised this issue again at the company's AGM, Philips announced that they had sold their stake in Dutch Aero. Philips acknowledged that this decision was in part due to the repeated engagement performed by ASN Bank and the VBDO.

2.6. Phase 5: Measure Impact and Communicate Outcomes

The final phase of the engagement process is to measure or evaluate the outcome of the engagement against the milestones and success criteria set in phase three. This phase also includes communicating the outcome to stakeholders and beneficiaries.

Since most engagement in Europe is non-public, the milestones and success criteria are not disclosed. Investors who publicise information about on-going or completed engagement processes will, in most cases, only disclose general information. However, many investors have a detailed internal process for evaluating the progress towards improvement or exclusion.

A recent paper by the European Centre for Corporate Engagement examines the private engagement practices of a large UK asset manager in the period 2006-11, covering 397 global companies on the investor's priority list.ⁱⁱ The number of firms on the list in any unique year ranges from 112 to 214. The research finds that the investor raised 6,837 objectives at the 397 firms, 40% of which were corporate governance related, 32% social related and 28% environment related. Interestingly, the number of social and environmental objectives increased more rapidly than corporate governance objectives in the period. The asset manager achieved 592 milestones in the period, a success rate of 8.7%. Corporate governance was the most successful (11.1%), followed by environment (8.6%) and social (5.6%). The paper explores a number of hypotheses, and finds, for example, that the investor exhibits home bias in its selection of companies for engagement and that a past engagement relationship is a significant driver of the presence of engagements. According to the paper, "[t]his finding alludes to the fact that the engagement business is also driven by long-term relationship building between firms and its major institutional shareholders."ⁱⁱⁱ In terms of communication, detailed outcomes are reported to the client base of the asset manager, but not to the public.

An example of public disclosure of engagement progress can be found in Sweden, where the Ethical Council of the AP1-4 funds measures progress and outcomes of the engagement process against defined goals. These are communicated to the public in the form of coloured bars ranging from no development to very positive development. In the 2012 annual report, the Ethical Council reports two completed dialogues that were successfully concluded: Goldcorp and Rio Tinto.ⁱⁱⁱⁱ

According to data collected by Eurosif, 16% of investors responding to the question (or 31 out of 189) publicly disclose the outcome of their engagement activities. This is less than half of the number responding that they have an engagement policy. The finding supports the hypothesis that most European investors are not yet disclosing the outcomes of these ESG Engagement processes. This is partly driven by the finding that engagement is typically a process with uncertain and sometimes long time-horizons before reaching a successful or unsuccessful outcome. Other reasons include investor or company fear of public criticism in case of negative achievement, or because investors wish to preserve their access to and relationship with the investee company. It may also be that some investors have only recently started engaging on ESG, and do not wish to disclose the outcome of on-going engagements.

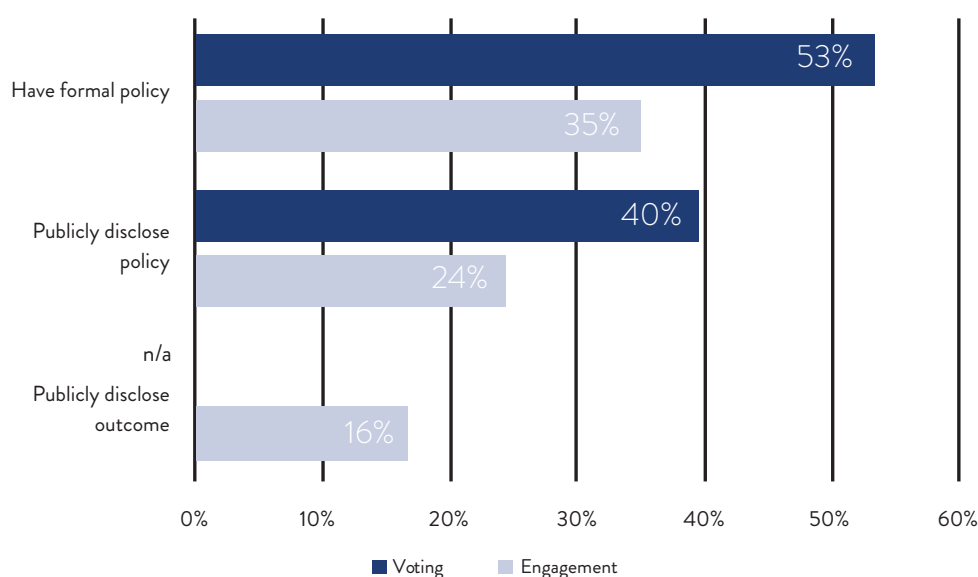


Figure 11: Engagement Policy and Disclosure (Source: Eurosif, 2013).

Having measured and communicated the outcome of engagements, the outcome of the engagement process, both successes and failures, should also feed back into the periodic evaluation of the engagement policy and process established by the investor. This periodic evaluation is necessary to incorporate the lessons learned through existing engagements and to incorporate new developments in responsible investment.

In summary, the final phase of the engagement process involves measuring outcomes against the success criteria set, communicating the results, and learning from the experience for future engagements.

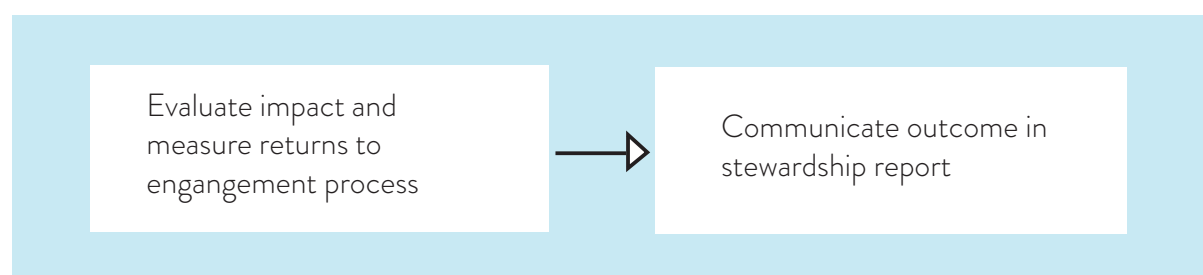


Figure 12: The Fifth Phase of Engagement (Source: Eurosif, 2013).

Illustration 8: PGGM

The following case study illustrates how an investor focuses its engagement efforts and increases impact through collaboration.

PGGM is a leading Dutch pension administrator with roots in the healthcare and social work sector. As of March 2013 it manages about €140 billion of pension assets for more than 2.5 million Dutch participants.

Water Scarcity in China and India

To focus its engagement efforts, PGGM Investments has identified for each of the three major sustainability 'pillars': environmental performance, social performance and quality of corporate governance, a number of specific themes to which it wants to contribute. One of the themes is the promotion of responsible use of scarce natural resources, including water. Water scarcity is a growing problem worldwide, but particularly urgent in fast-growing economies such as China and India. Although the sustainable management of a country's water resources ultimately is a government's responsibility, companies have an interest in reducing their own water demands and promoting collective water security.

PGGM's Sustainability 3 x 3 matrix

Enviromental	Social	Corporate Governance
A stable climate • By reducing greenhouse gas emissions	Respect for universal human rights including ILO labour rights . • e.g no child labour, freedom of association	Adequate shareholder rights • e.g. voting, proxy access, nomination directors
Responsible use of scarce natural resources • e.g efficient use of water and preservation of biodiversity	Adequate provision of basic needs • e.g health care and nutrition	Effective board structure and risk management • e.g independence of directors, strategy, remuneration
A clean and healthy environment • e.g reduced waste and pollution, increased recycling	Local socioeconomic development • e.g creation of employment, knowledge transfer	Proper accountability • e.g disclosure and transparency, culture, anticorruption and bribery

PGGM's Sustainability 3 x 3 matrix
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Figure 13: PGGM Sustainability 3x3 Matrix (Source: PGGM, 2013).

Jointly with Norges Bank Investment Management (NBIM), in 2012 PGGM began to urge mining and electricity companies in China and India to measure and manage their water risks.

Mining and electric power are two sectors that are highly dependent on a continuous supply of water. Investors need to know the water dependency ('footprint') of companies and understand the risks to the continuity of their water supplies. They also want to know what companies do to reduce those risks.

Investors need such information because the price of water (and its cost to business) rarely reflects its scarcity, or the risk of running dry.

It is therefore very important that companies report the relevant information, not just on their (internal) water use and efficiency of use, but also on the (external) security of their water supply.

Together with NBIM, PGGM Investments is encouraging a number of sector-leading mining and electricity companies in China and India to disclose information on their water risks and water risk management through the CDP Water Disclosure Project.

PGGM Investments entered into direct discussions with three Indian electric power companies and attended events in the region, such as the Singapore Water Week and workshops in New Delhi and Hong Kong, to present the business case for better water risk management and reporting. That business case revolves around water scarcity (and pollution) as constraints to company operations and growth.

One milestone has already been achieved: one of the Indian electric power companies has begun to carry out water assessments at its power plants.

2.7. Consolidating the Engagement Framework

Having presented and explained the five phases of engagement, the individual elements can be placed into a unified structure to show the full engagement process.

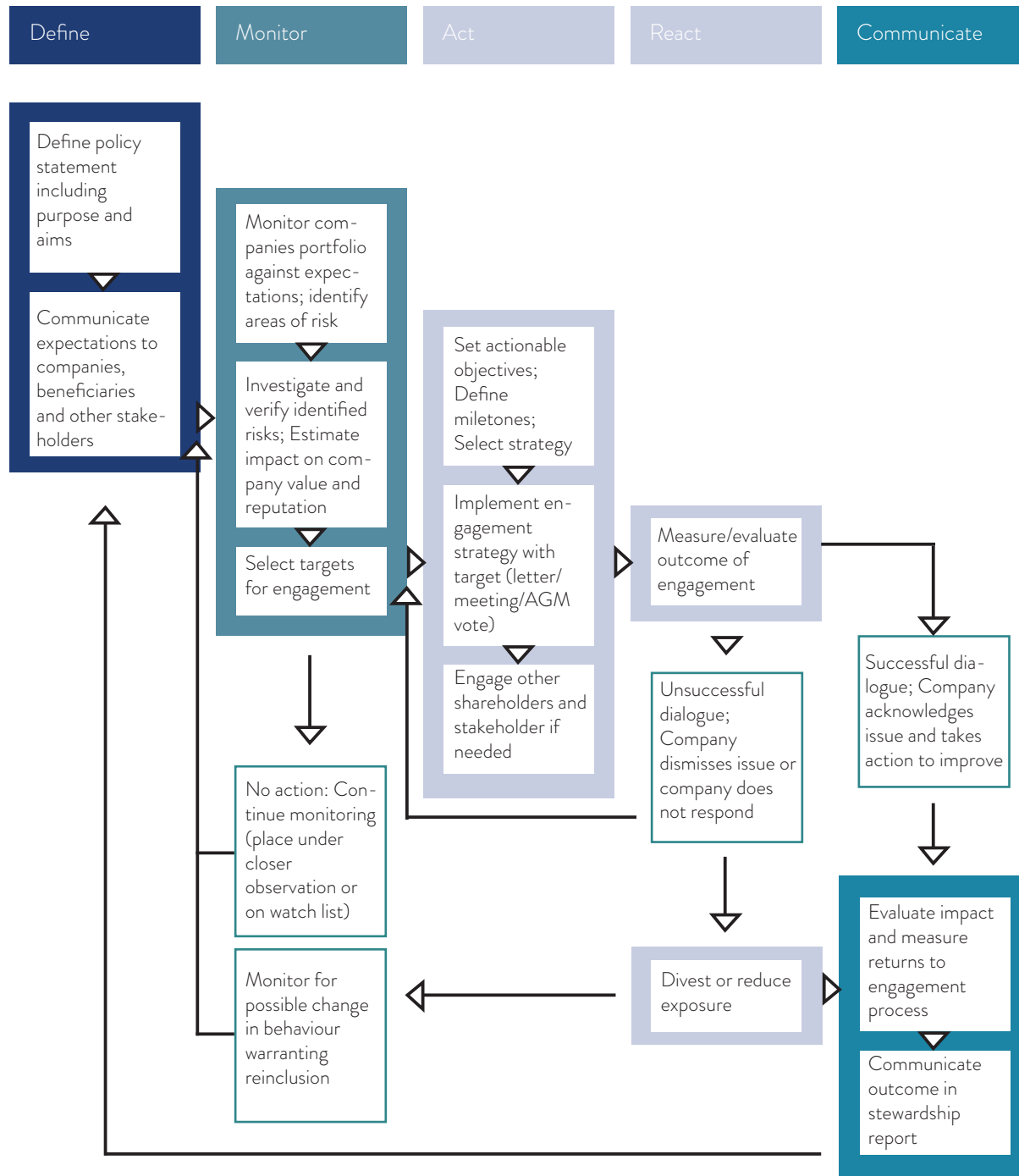


Figure 14: The Consolidated Engagement Framework (Source: Eurosif, 2013).

The figure shows how engagement starts with defining a clear general policy and subsequently specific and measurable purpose for engagement. This policy flows into the monitoring and evaluation of companies in the portfolio, which can lead to two outcomes: either no immediate action, or the company is selected for the next stage of the process. The first engagement with a selected

company can involve a number of different strategies, including letters and meetings. In case of unsuccessful dialogue the investor can either escalate the engagement activity or decide to reduce exposure to the company. This cycle of acting and reacting can take many turns before an outcome (be it positive or negative) is decided. The final phase is to measure the effect of engagement, and communicate the outcome to stakeholders.

The circular nature of engagement also allows this knowledge to feed into the start of the process at regular intervals in order to update the policy and company expectations. The key areas to consider in this framework are that the policy is general in nature, but the engagement objectives must be specific and measurable in order to increase chance of success.

2.8. Value Creation and Measurement

Throughout the phases of the engagement process, it is important for investors to connect the value created to the overall investment process. Divorcing the engagement from the rest of the fund management and stock selection activity runs the risk of pursuing separate goals with the same investment.

The Association of British Insurers (ABI), for example, notes that: “In managing assets, asset managers have a duty to protect their clients’ interests. In turn, therefore, they have a duty to be responsible shareholders of the companies they invest in. More generally, ABI members see effective shareholder engagement as an integral part of the investment process and therefore as a means to generate outperformance over the long-term.”^{liv}

Evidence from investors shows that the value created from ESG engagement is measured in different ways and depends on the objective of engagement. Value creation is often described in broad terms related to sustainable development, especially when considering environmental or social issues. Corporate governance issues, such as composition of the board of directors, auditor independence or aligning executive compensation with shareholder value, are often more straightforward to connect to performance and risk management because outcome are more immediate and measurable.

Many investors are increasingly using scientific evidence of future risk scenarios to minimise the potential risk from global environmental and social hazards. These can include evaluating the environmental impact from the carbon footprint or intensity of the portfolio or reviewing companies’ labour-rights performance, to mention just two issues. As noted, the objective is often to protect the portfolio from future environmental and social risks.

For example, Storebrand, a Norwegian insurer and asset manager, has reportedly excluded investments in 13 coal and 6 oil sands companies to ensure long-term stable returns because it argues that these stocks will potentially be worthless in the future. “If global ambitions to limit global warming to less than 2 degrees Celsius become a reality, many fossil fuel resources will become unburnable and their financial value will be dramatically reduced,” a Storebrand spokeswoman said in a press release.^{lv} In another example, Rabobank, a Dutch bank and asset manager, is reported to have ceased lending money to unconventional energy extraction projects, such as shale gas and tar sands, because of the environmental and social implications.^{lvi}

While these two examples specifically involve the exclusion of companies with perceived high risks from environmental issues, the action can be extended to engaging on these same issues to reduce the risk of portfolio companies. An investor that manages a portfolio according to an investment

scenario where companies' fossil fuel reserves are overvalued by the market because the asset will be worth less in the future is likely to not only incorporate this belief into asset allocation decisions, but also in their engagement efforts.

In general, the financial value created from reducing the portfolio risk through ESG Engagement is based on two time horizons:

- Short-term risks: These can originate from business conduct such as supply-chain management or environmental impact, and are measured in terms of success criteria and milestones. They can also be associated with poorly managed companies, whose value can be unlocked in the medium term through engagement.
- Long-term risks: These come from changing patterns of demand, increasing cost from regulation, and internalising ESG costs which now are external. These are measured by reducing portfolio exposure to indicators such as carbon footprint, biodiversity and water efficiency.

In both cases, the financial benefit (or alpha) is challenging to measure and will generally only manifest itself in the long term. In the long term it also becomes challenging to separate performance through ESG Engagement from other factors. Thus, using indicators as a proxy for generating financial value based on the evidence that ESG issues have an impact on the portfolio in the long term is a common way to demonstrate value creation.

However, there are exceptions. CalPERS, a large US asset owner, commissioned a study on the value generated by engagement. Using data from 169 companies, 110 of which were private engagements and 59 of which were publically named on a Focus List, the study found that over the last 11 years, the companies produced a total cumulative excess return of 11.59% above their benchmark three years after first engagement, and 4.77% after five years. However, there was a big difference between privately engaged companies and those companies named to the public Focus List. While privately engaged companies outperformed their benchmark by 17.86% over five years, the publically named companies underperformed their benchmark by 20.88%. CalPERS has since ceased to use the public Focus List, but historically only the “worst offenders resistant to governance reform” were named.^{lvii} This suggests that a combination of engaging for change and excluding the companies resisting improvement can be a powerful combination to generate out-performance from engagement.

More specifically on engagement, Dimson et al, using data from an asset manager on engagements with US companies in the period 1999-2009, finds that engagements on ESG concerns are followed by one-year abnormal return that averages +1.8%, comprising +4.4% for successful and zero for unsuccessful engagements.^{lviii} Moreover, companies experience improvements in operating performance, profitability, efficiency, and governance in the years following engagement.

Illustration 9: Doughty Hanson

The following case study illustrates how a private equity firm uses ESG Engagement to generate value for clients.

As a private equity firm with a 27-year investment history, Doughty Hanson has long recognised the importance of undertaking business in a responsible manner. They believe that

Environmental, Social and Governance (ESG) matters can have a significant future impact on private equity investment, both in terms of raising funds, making investments and managing portfolios. Firms that have a more environmentally sustainable and socially responsible way of operating significantly de-risk their business model and can achieve greater cost efficiencies and profitability, attracting higher valuations in the capital markets.

Doughty Hanson's approach is to treat ESG as integral to the business, both at a firm level and within their portfolio, and they have implemented policies and practices that achieve this. However, the focus is on their portfolio because this is where they can make the biggest impact, specifically through value enhancement and better risk management by adopting a more sustainable approach to doing business. Doughty Hanson is highly proactive and addresses a wide range of ESG issues throughout the lifecycle of an investment (as part of their investment decision making process, and continued post-investment and through to exit).

They are better able to achieve this due to a culture of active ownership and in-house ESG expertise, supported by access to a wide network of external specialists. Their efforts are coordinated by a qualified, dedicated Head of Sustainability who is a partner within the private equity team and with over 20 year's practical ESG expertise.

Doughty Hanson's approach is to work with the portfolio to identify, manage and act upon ESG risks and opportunities. They identify what works well, decide what is needed to validate as working well and identify gaps for value enhancement and risk management. In-house, embedded expertise helps to make sure this happens and that ESG is properly planned for and targeted action taken.

Rather than simply relying on reporting what a company is already doing, they seek to validate and enhance what exists and instigate new initiatives where necessary. Their approach is to also play an active supporting role in the event of an ESG incident or crisis.

They do not focus on any one aspect of ESG, but seek to understand how all applicable ESG issues might impact an investment during its lifecycle. There are programmes underway at all of their companies, but they tend to focus on those issues of most material impact to an investment and for a successful exit. Examples of the type of initiative Doughty Hanson validates or instigates include:

Managing risk

- Identifying and mitigating ESG risk within an investment (e.g. supply chain assessment, product life cycle assessment, provision of training, behavioural safety)
- Professionalising a firm from the perspective of ESG management
- Recruiting senior executives and/or plant level specialists
- Developing policies, processes and procedures
- Formalising management systems and reporting processes
- Growing the top line
- Identifying opportunities to develop new products and services
- Validating existing products and services
- Saving money
- Reducing cost through environmental efficiency (e.g. energy, water, waste) and/or improved health and safety (fewer accidents and reduced insurance costs)

Doughty Hanson's efforts to date have resulted in over €25 million EBITDA through improved environmental efficiencies and safety; €4 million in additional new revenue from new products; reduced risk and avoided unwanted cost; helped make exits proceed smoothly; and, improved performance (reduced carbon emissions, increased waste recycling and reduced water use).

A typical engagement will ultimately seek to address all the relevant material ESG aspects of a business.

For example, at LM Wind Power, Doughty Hanson have saved over €11 million since 2010 through improved energy management and waste reduction, and at the same time enhanced safety by reducing the frequency of accidents by 42%. They also supported supply chain sustainability, product life cycle assessment, the development of new to market low solvent coatings, and successfully signing up to the UN Global Compact, amongst others.

At carpet manufacturer Balta, addressing energy efficiency and installing on site solar power resulted in cost savings and additional revenues of €1.7 million a year and saves 4,750 tonnes carbon annually. Providing training and improving the safety culture has resulted in improved performance and reduced lost time and savings of €1.6 million.

Doughty Hanson believes all this better positions their businesses for exit.

For example, at packaging business Impress, sold in 2010, initiatives contributed to a 50% reduction in accident frequency rate, 500 tonnes of waste recycled a year, 1,800 tonnes of carbon emissions saved a year, and equating to €2 million a year savings or €12 million (6x Exit Multiple). This represented 3% of the €380 million of equity value or 5% of the overall €40 million in annual cost savings generated at the time of exit, and Doughty Hanson had only just started to really engage at that company.

At a fund level, Doughty Hanson introduced an annual ESG reporting process to capture performance data across the portfolio and to help inform their value creation works. They also undertake bespoke fund-wide ESG assessments as required.

SECTION 3

ENGAGEMENT IN A
BROADER CONTEXT

3.1. Combining Engagement with other SRI Processes

In the European SRI Study 2012, Eurosif identifies seven different Sustainable and Responsible Investment (SRI) strategies. Industry participants acknowledge that most asset managers use several strategies in combination, often to achieve different objectives.

ESG Engagement is no exception, and is frequently used in combination with one or more other SRI strategies. ESG Engagement is a responsible investment strategy that is often used for the purpose of achieving incremental advances in sustainability reporting or ESG performance of companies. As such, it is commonly combined with other portfolio construction (security selection) strategies as a way to achieve a holistic investment strategy. In order to see which combinations of strategies are common and why, Eurosif studied data from nine countries^{lix} covering 140 responses weighted by assets.

The results of first taking the total figure for ESG Engagement for the countries, and looking at what proportion of the total is combined with each of the other strategies is shown in Figure 15. The most common responsible investment strategy combined with total ESG Engagement assets is ESG Integration, which is a strategy where ESG information is combined with financial information for valuation purposes. Using data from nine European countries, Eurosif finds that almost 70% of all ESG Engagement assets are also subject to ESG Integration. The second most common responsible investment strategy combined with ESG Engagement is Exclusions (43%), followed by Norms-based screening (25%).

This finding that it is common to combine ESG Engagement with ESG Integration also supports evidence that ESG Engagement is becoming more integrated into the traditional investment process.

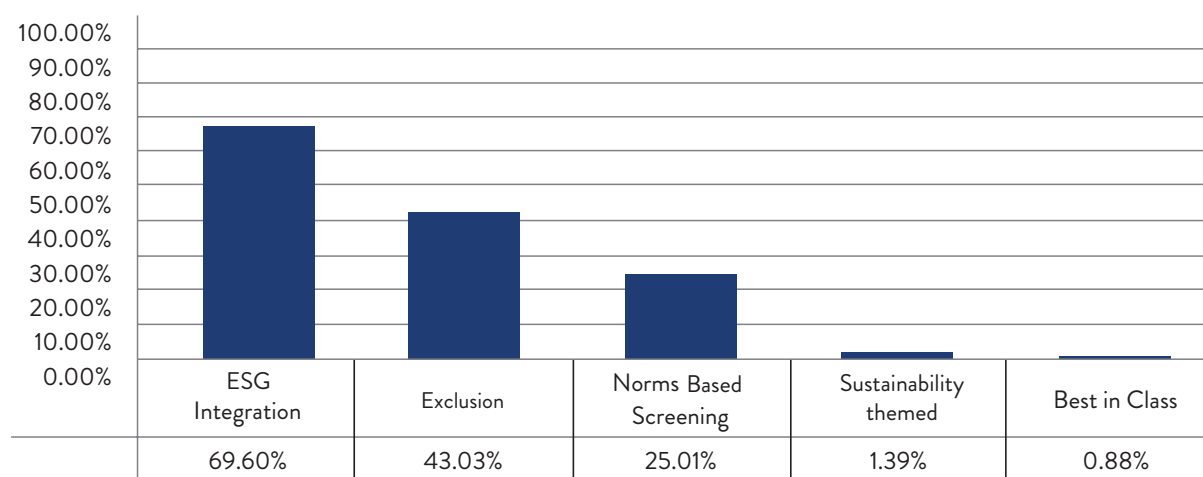


Figure 15: ESG Engagement Combined with SRI Strategies (Source: Eurosif, 2013).

Few ESG Engagement assets relative to the total are combined with thematic funds and Best-in-Class assets, but can be explained by the smaller absolute number of assets covered by these strategies.

Of the nine countries examined for this data, there are three that stand out because they have a very high proportion of ESG Engagement assets relative to the total assets covered by an SRI strategy. Denmark, the Netherlands and the UK all have more than 70% of total SRI assets cov-

ered by an ESG Engagement strategy. However, there is great variability in the use of combinations within these three countries. In the UK, it is common to combine ESG Engagement with ESG Integration. In Denmark, it is common to combine ESG Engagement with Exclusions and Norms-based screening. In the Netherlands, it is common to combine ESG Engagement with Exclusions and ESG Integration.

If one looks at the converse, or how much of the total assets of an individual responsible investment strategy is combined with ESG Engagement, the most frequent combination is also ESG Integration. As seen in Figure 16, of the total ESG Integration assets in the nine countries, almost 90% is also combined with ESG Engagement. The second highest use of ESG Engagement in combination with another responsible investment strategy is Sustainability Themed Investment, with 67% of all such assets combined with ESG Engagement.

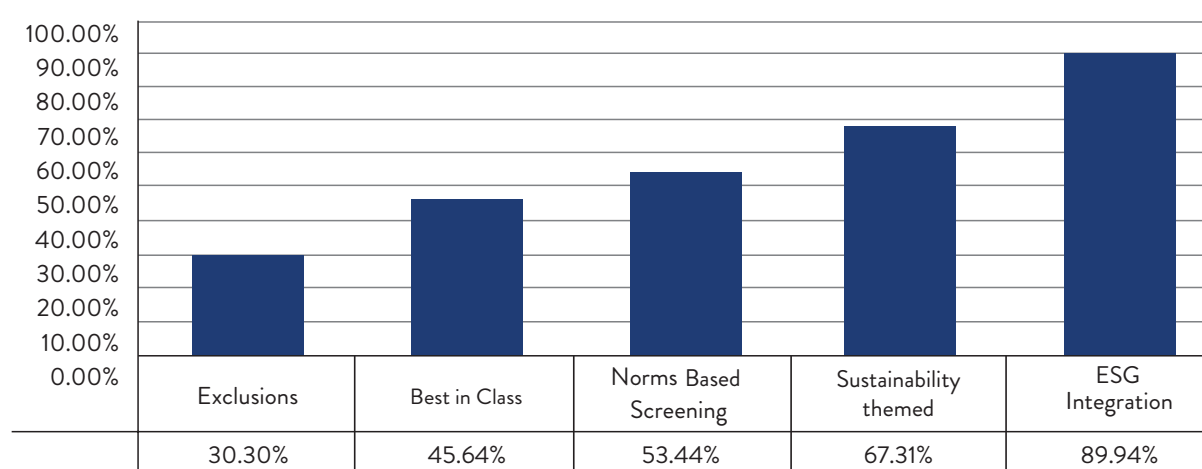


Figure 16: SRI Strategies Combined with ESG Engagement (Source: Eurosif, 2013).

The data also show that it is common to combine ESG Engagement with not just one, but also two or three SRI strategies across assets. The extent of combinations of SRI strategies is significant because it shows that investors use different strategies for different purposes. For example, considering the nature of ESG Engagement one can argue that it is more suitable for achieving incremental improvements in existing company practice and conduct than it is achieving a fundamental shift to more sustainable consumption and production. This is because most ESG Engagement is aimed at evolutionary changes rather than revolutionary. If an investor wants to finance innovative new technologies that have the potential to change the world it therefore makes sense to combine ESG Engagement with Sustainability Themed assets. This does not imply that one strategy is more important than the other; they simply serve different purposes in achieving the overall investment objective of the investor.

Illustration 10: Etica SGR

This case study illustrates how a sustained relationship between investor and company can develop into a successful partnership.

Etica has been investing in Indesit, an Italian appliance manufacturer, since 2003, in part due to its good ESG profile and constant commitment to a responsible management. For example, for a number of years, Indesit has been publishing a Sustainability Report, which in 2011 was awarded the level A+ of the Guidelines of GRI.

Etica has been attending the Indesit AGM every year since 2005, developing a continuous dialogue with the company about ESG issues. Moreover, Etica has regular meetings with the company's investor relations team through phone calls and meetings. Indesit is transparent about this dialogue in its Sustainability Report and reports on the presence of Etica among its shareholders as an ethical investor in order to underline the importance of the dialogue with Etica for Indesit's CSR commitment.

At the first shareholder meeting it attended, Etica requested more transparency on the environmental certification for all company's plants. As a result, Indesit included the information requested in its Sustainability Report of the following year.

In 2008, Etica stressed the importance of adopting a selection and monitoring policy for suppliers based on ESG criteria. At present, Indesit selects its suppliers according to ESG targets (comprising 10 environmental indicators and 11 on health and safety) and it monitors suppliers' compliance through online surveys and auditing conducted by the Supply Chain Quality Unit.

In 2010, Indesit joined a project promoted by Etica in Italy and launched by the PRI about gender diversity at companies' management levels. The goal of the project was to identify companies with leading policies and programs aimed to promote gender equity in corporate leadership and to encourage increased transparency with respect to gender empowerment.

A few years ago, as a consequence of the crisis, Indesit decided to move part of its production to Poland, where working and production costs are lower than in Italy. Etica urged Indesit to pay particular attention to the issue of job stability, asking for information about the relocation of workers of the plants that have been closed and moved abroad. Indesit disclosed its relocation policy to Etica, which demonstrated all the proceedings that have been implemented by the company and showed that no employees had been fired.

3.2. Collaborative Engagement

Collaborative engagement (also referred to as collective or pooled engagement) is where two or more investors collaborate on engaging on a topic or range of topics with a company. It is significant because it reduces costs and increases the probability of a successful outcome. Investors, especially asset managers, have limited budgets and therefore capacity constraints. Being able to share costs and knowledge reduces both the time and resources each investor needs to dedicate to an engagement effort. Further, due to the power of voice, the larger the collective ownership

of a company an investor group can use as leverage to affect change, the better chance it has of succeeding.

For example, UK pension fund USS states:

“Where appropriate, the fund may engage with companies in collaboration with other pension funds and asset managers. These collaborative engagements add weight to USS’ engagement and stewardship activities (as more funds = more assets = more impact), spread the costs of such action across the investors involved, and can help to increase the geographic reach of the fund.”^{ix}

The collaboration between investors is most often informal. Likeminded investors who have similar approaches to ESG risk management will often be known to each other, making it straight forward to temporarily pool their respective resources and capital for a specific purpose. Informal networks also exist where investors can approach other investors for support of an engagement effort. Often, an investor will approach other investors in the escalation phase if an engagement is not proceeding well, and additional voices may be needed to sway the company to take action. Sometimes, investors will form a collective group in advance of an engagement in order to make an immediate impact early in the phase.

According to the Eurosif data on investors’ use of engagement strategies, collaborative engagement is the second most common form of engagement (27%) after private engagement conducted individually (39%).

Several of the respondents to the Eurosif survey mention that these collective engagements are managed through companies specialised in engagement. Investors will effectively outsource the task of engagement to a third party with expertise, resources and processes necessary for managing the engagement. This is especially common for investors starting to engage outside of their home market, as this requires a new set of skills that may be difficult for the investor to internalise. These companies also generally manage engagements on behalf of several investors, allowing them to benefit from the power of pooling assets. Two of the case studies in this report cover outsourced collaborative engagement: GES and Hermes EOS.

The UN-backed Principles for Responsible Investing (PRI) also offers signatories a platform for collaborative engagement through the PRI Clearinghouse. This private forum allows investors to pool resources, share information, enhance, influence and engage with companies, stakeholders, policymakers and other actors in the investment value chain on Environmental, Social and Governance (ESG) issues across different sectors and regions. According to the PRI, close to 400 signatories have been involved in at least one collaborative initiative since the platform was launched at the end of 2006, and over 400 collaborative proposals have been posted.^{ixi}

Engagement collaborations also exist at the national level. For example, the Swiss Ethos Engagement Pool engages on behalf of its members in dialogue with the management of the 100 largest Swiss listed companies. Membership is restricted to Swiss pension funds. Ninety-one pension funds are members of the Ethos Engagement Pool, managing total assets of CHF 117 billion. The pool members choose the topics for engagement annually.^{ixii}

Illustration 11: Hermes EOS

The following case study illustrates how one collaborative platform used sustained engagement to achieve corporate governance changes.

Hermes Equity Ownership Services (Hermes EOS) is a UK based organisation that helps institutional shareowners around the world to meet their fiduciary responsibilities and become active owners of public and private companies. Established in 2004, Hermes EOS has annual engagements with over 500 companies in more than 50 countries.

Hermes EOS had long held concerns about the corporate governance at Infineon AG before escalating their engagement in 2008. Most importantly, delays in strategic decisions or in their implementation, as well as questionable management board appointments, are likely to have contributed to a significant destruction of value since Infineon's listing in 2000. Due to its responsibility for strategic and investment decisions, and in particular the appointment of management board members, the supervisory board was ultimately responsible for this value destruction.

Since October 2008, Hermes EOS had discussed these concerns with members of the supervisory board and made constructive proposals with regard to addressing the apparent problems and regaining investors' confidence. Given the apparent failure of Infineon to recognise the seriousness of concerns amongst investors, Hermes EOS filed a counterproposal at the AGM in February 2009 regarding the discharge of the supervisory board. The support for Hermes EOS' counterproposal of close to 50% of the votes cast was unprecedented at a major German company, and showed shareholders' lack of confidence in the work of the board members. Moreover, it was a clear demand for extensive renewal of the supervisory board at the AGM in 2010.

Unfortunately, the subsequent dialogue with Infineon once again did not prove fruitful, particularly with regard to the candidates proposed for election to the supervisory board at the AGM in February 2010. In fact, the supervisory board seemed to ignore the wishes of shareholders by nominating four of its members for re-election at the 2010 AGM. The proposal to re-elect a former Siemens executive was particularly problematic as he had been on Infineon's supervisory board since 1999 and was proposed as chairman. Hermes EOS strongly believed that a new start at Infineon required further renewal, particularly at the top of the supervisory board.

In January 2010, Hermes EOS proposed a very experienced and qualified alternative candidate for election to Infineon's supervisory board. This was the first time that shareholders had presented a candidate for election to the supervisory board of a major German company and as such it was a significant milestone in the development of responsible ownership practice in Germany. In the week after filing their proposal, Hermes EOS won very strong public support from a number of international and German investors, as well as the proxy advisory firms, for their initiative. As a result, the company's candidate for the supervisory board's chairmanship offered to step down in late January after only one year if elected – generally supervisory board members are elected for five years in Germany – and promised to identify a suitable successor from the outside during that period in consultation with major shareholders. On the

basis of this unprecedented concession, the company's candidate was elected at the AGM in February 2010.

At the AGM in February 2011, following a dialogue with a number of shareholders, the company proposed a strong, independent candidate for election to the supervisory board and to take over from the chairman. As such, Hermes EOS achieved the objective of their engagement. Hermes EOS also contributed to the development of corporate governance practice at Infineon and - even more importantly - in the wider German market. Indeed, the effect of Hermes EOS' engagement on supervisory board nomination practice has been described by some commentators as a sea change in German corporate governance.

3.3. Investor-supported Initiatives

Investor-supported initiatives are a second significant vehicle through which investors can exert large-scale influence on companies, financial markets and policy makers. These initiatives are usually concentrated around specific ESG themes that are material to investors such as climate change, human rights, labour rights, tax-justice, corruption and supply-chain management, to name just a few. There are too many such organisations in existence globally to mention here, but the following two can serve as examples.

CDP (formerly known as the Carbon Disclosure Project) is an example of an investor-supported non-profit organisation that engages with companies for the purpose of disclosing information to stakeholders. In doing so, CDP provides a global system for companies and cities to measure, disclose, manage and share vital environmental information. It is backed by 722 investors holding over \$87 trillion in assets, an indication of the value of the information collected and distributed by CDP and the companies that use its framework. In addition to disclosure, CDP works to motivate companies to disclose their impacts on the environment and natural resources, and take action to reduce them. Originally focused on climate change risk disclosure, the CDP has expanded its work to encompass water, forests and supply-chain as well. It is also affiliated with the Carbon Disclosure Standards Board (CDSB), a collaborative forum to improve existing standards and practices on climate-change related reporting, aiming to link financial and climate change-related reporting to provide policy-makers and investors with clear, reliable information for robust decision making.

The Extractive Industries Transparency Initiative (EITI) is an example of an international standard that is supported by investors. It is a global standard that promotes revenue transparency and accountability in the extractive sector. EITI is a multi-stakeholder organisation, which is supported by over 80 global investors managing more than \$19 trillion. Originating from the 2003 Lancaster House Conference, its principles are the basis for the EITI standard that ensures transparency around countries' oil, gas and mineral resources. The standard is a robust yet flexible methodology for monitoring and reconciling company payments and government revenues from oil, gas and mining at the country level. Each implementing country creates its own EITI process adapted to the specific needs of the country. Currently, there are 23 EITI compliant companies, and once a host country endorses the initiative, the EITI process is mandatory for all extractive industry operators (including those that are state-owned) operating within that country.

These two initiatives are slightly different, in that the CDP is primarily focused on eliciting standardised disclosure from companies globally in order for investors to be able to assess climate risk. The standard is voluntary at company level, but can also serve as an example for policy makers

looking to set minimum standards of disclosure. The EITI is a standardised framework implemented through country legislation, so once implemented all impacted companies must use the framework.

Interestingly, both organisations have been very active at promoting their missions at EU level. The CDP has given input to the legislation proposed by the European Commission on non-financial reporting by companies. The EITI is referenced in the new Accounting and Transparency Directives, and while implementation of the EITI at country level is not part of the legislation, the Commission states that: “The EU mandatory disclosure requirement will complement the EITI efforts by legally requiring companies registered or listed in the EU to disclose payments to governments along the same lines as EITI. In doing so, the ultimate objective is to contribute to the strengthening of the EITI and to extend its scope to all resource-rich countries.” ^{ixiv}

3.4. Engaging Policy Makers

Investors will also, individually or collectively, lobby national and supra-national policy makers on matters of importance to them.

Direct action can be taken for example through responding to public consultations on proposed legislation, by participating in formal or informal expert groups, and by meeting with policy makers such as members of legislative bodies. At EU level, it is common for investors to make their views heard to the European Commission and to the two co-legislators, the European Parliament and the Council of Ministers. Specifically, many investors were active in promoting the EITI to European policy makers with the aim of increasing transparency in extractive industries.

Further, there are a number of indirect paths to make one’s view known to policy makers. For example, member associations such as Eurosif are vocal on matters that affect its mission at the EU level, such as proposed legislation on non-financial reporting by companies, corporate governance and investor disclosure on ESG issues. Eurosif frequently meets with policy makers to provide input to the legislative process, in order to inform and influence the decisions made.

These initiatives are just some of the investor-led or supported initiatives that provide platforms for engagement, that contribute to improved disclosure and practice, and that aim to inform and influence policy makers. Given resource constraints, investors will often choose a limited number of initiatives to be involved in. However, collectively these and similar organisations have a substantial impact on the ability of investors to manage risk on ESG issues.

Illustration 12: RWC European Focus Fund

The RWC European Focus Fund ^{ixv} is an active ownership investment fund that seeks to generate value through investing in a small number of fundamentally sound companies that are not valued to their full potential due to factors that can be remedied by the company and where it believes it can act as a catalyst for the change required to unlock value. It seeks to add value to companies and generate shareholder returns by constructively working with management and supervisory boards as well as other shareholders. The fund also aims to exploit temporary discounts caused by short-term orientation of the financial markets on companies undergoing change. The approach is enabled by an in-depth understanding of and a long-term view on companies’ fundamentals and transformational opportunities as well as the team’s ability to

effectively engage with the management, the Board and other shareholders and stakeholders to address those opportunities.

RWC's efforts as an active owner are focussed on addressing issues that are either directly or indirectly driving value:

- Improving economic value creation through strategy and capital allocation, operational excellence and capital structure;
- Reducing the discount of a company's shares through interaction with capital markets;
- Improving corporate governance as an enabler of economic value creation and contributor to reducing the discount of a company's shares.

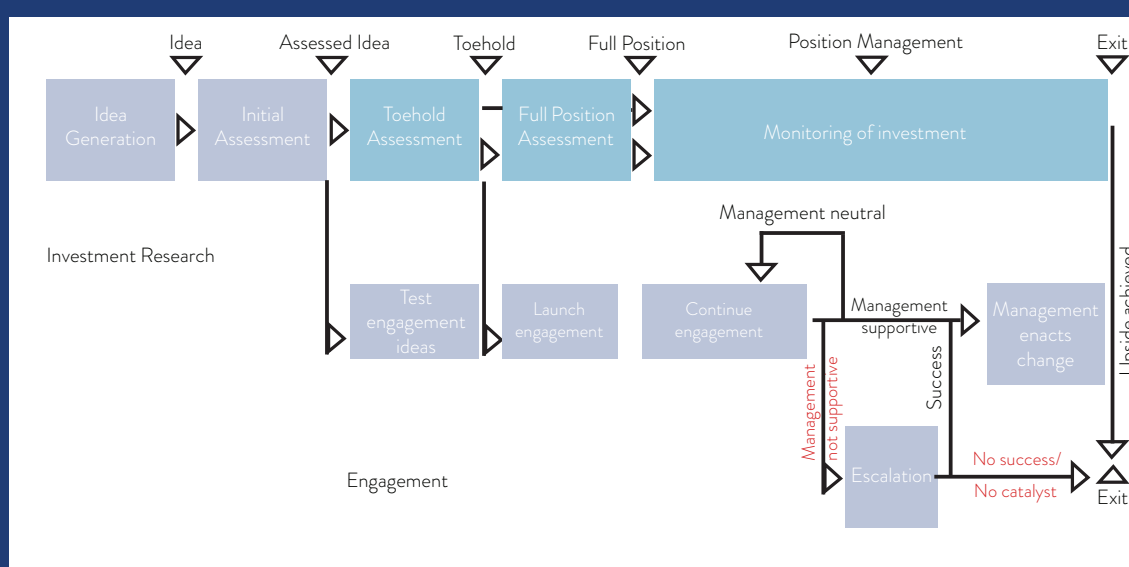


Figure 17: RWC EFF Investment Process (Source: RWC Partners, September 2013)

The fund managers will build a detailed case for transformation and work with the company in a constructive manner in order to help unlock sustainable value. This will often require corporate governance improvements, such as changing the Board and improving shareholder rights. Environmental and social issues are similarly important if connected to materiality when they have a material impact on value creation (e.g., increasing revenue, productivity or improving the company's risk profile). At the time of writing, the approach has delivered annualised returns of 8.87% in excess of its reference index of European listed companies since the fund's inception in February 2009.

Improving corporate governance was key to the fund's investment in Océ, a digital printing equipment company based in the Netherlands, which is one of the most successful engagements of the fund. The fund made the initial investment in November 2006, and exited in March 2010 when Océ was acquired by Canon. The investment case in Océ was predicated on the company having a high-end and innovative printing equipment business with a profitability and valuation that was not reflecting its potential. The fund maintained that there was a business logic for participating in consolidation for Océ in the oligopolistic printing equipment industry given that, although the company had strong positions in several niches, it was sub-scale in the more mainstream activity of developing, producing and servicing printing equipment for offices. As a result the company had been suffering and had seen its margins grad-

ually erode over a period of ten years. Combining Océ's R&D activities as well as its installed base with one of the four leading players in the industry could be significantly synergistic and could substantially improve the competitiveness and cost structure of the company. At the same time, this would also unlock the fundamental value of the company for its shareholders, as the share price was strongly discounted. At the time of investing, the company was still insulated by several takeover defences and focussed on a standalone strategy. The fund initiated a process comprising three phases, each lasting about one year:

- Enabling change through corporate governance improvements,
- Negotiating a change in strategy through engagements with the board, and
- Contributing to the process of maximising value before exit.

The first phase of the engagement process involved improving the corporate governance of the company by giving more power to shareholders on Supervisory Board nominations and reducing some of its takeover defences. The second phase involved making the case to the management and the Supervisory Board for strategic change. This was supported by the fund bringing to the Supervisory Board a trusted individual with strong experience in corporate transformations. The company reacted by initiating a strategic process to assess and evaluate all its strategic options, which was made public by the company in April 2009. In November of that year, Canon announced an offer for Océ that was supported by the Océ's Supervisory Board. While the bid was at a 70% premium, many investors thought it was still too low given that it came at a low point in the company's share price following the financial crisis. The fund attempted to engage with Canon, who at this point had obtained a substantial portion of the voting capital of the company, but Canon declined to enter into a meaningful dialogue with shareholders. At an EGM in February 2010, key governance changes were voted through by Canon, which consolidated their control. The fund challenged these changes in the Dutch enterprise court, in order to improve the rights of shareholders that did not want to tender their shares. Disappointingly for shareholders, the court decided that Océ's Supervisory Board had appropriately represented all its stakeholders in its actions. Having no reasonable alternative, the fund tendered its shares.

The corporate governance and strategy changes initiated by the fund contributed significantly to unlocking value at Océ. The investment also contributed almost 6% to the excess return of the fund relative to its European reference index. In addition, the Océ case has informed a broader debate on the potential for the Dutch Ministry of Finance to modernise its takeover code.

SECTION 4

ISSUES OF PUBLIC POLICY AND THE
FUTURE OF ENGAGEMENT

4.1. Takeaways on Public Policy Matters

European Union and national policy makers generally acknowledge the positive effect that appropriate and constructive shareholder oversight can have on an economy. Absentee shareholders can impose a cost on society by allowing value destruction to go unchecked.

The European Commission, for example, states that;

“[A]n effective corporate governance framework is of crucial importance because well-run companies are likely to be more competitive and more sustainable in the long term. Good corporate governance is first and foremost the responsibility of the company concerned, and rules at European and national level are in place to ensure that certain standards are respected ... Shareholders have a crucial role to play in promoting better governance of companies. By doing this they act in both the interest of the company and their own interest. However, the past few years have highlighted shortcomings in this area. The financial crisis has revealed that significant weaknesses in corporate governance of financial institutions played a role in the crisis ... In particular, there is a perceived lack of shareholder interest in holding management accountable for their decisions and actions, compounded by the fact that many shareholders appear to hold their shares for only a short period of time.”^{lxvi}

This view also connects back to the previous discussion on fiduciary duty. If, by promoting better governance, shareholders are acting in their own interest, then they likely also have a duty to promote better governance on behalf of their beneficiaries. Therefore, the lack of oversight of companies by many shareholders has understandably caught the attention of European policy makers. The expected legislative proposal from the Commission on disclosure of engagement and voting policies and voting records by institutional investors is just one example.

In general, policy makers are able to influence conduct of companies and investors by setting minimum standards and by promoting best practices. In EU legislation there are minimum standards of corporate behaviour and transparency entrenched in legislation (national or supra-national), and there is best practice guidance in recommendations and codes of conduct. Poor performance on compliance can be an indicator to investors of a poorly run company that should be further analysed for possible engagement. Absent this oversight by investors, dubious practices may continue, leading to the eventual failure of the company. Conversely, companies can signal commitment to good performance by adhering to best practice standards and actively promoting corporate sustainability. Many companies do this well, and are important contributors to advancing standards and practices. In many cases, however, it is not the leaders that are the focus of engagement, but the laggards.

Further, as noted in this report, most engagement activities with companies have one of two aims: increasing disclosure and improving behaviour. However, the two are often linked since disclosure is usually a necessary precondition to assessing behaviour. If there is no disclosure, then the company is potentially at risk from an issue. Disclosure allows the investor to assess the risk and take appropriate action to influence behaviour.

4.1.1. Disclosure

In order to facilitate engagement and reduce costs for investors from engagement, policy makers should ensure a sufficiently high level and quality of disclosure on ESG issues. Requiring disclosure on ESG issues through legislation removes much of the need to engage for disclosure. This allows

the investor to focus the engagement resources and activity on assessing risk and evaluating the need for engaging with the aim of changing behaviour.

One can argue that transparency is the single most important contributor to constructive engagement that policy makers have the ability to influence. Companies need to disclose relevant, comprehensive, comparable and timely information to investors, in order for investors to be able to assess the risks of their investment. This disclosure is based on minimum standards set out in legislation, but also voluntary best practice standards and disclosure frameworks. While best practices are best developed by international multi-stakeholder groups, minimum standards should be enshrined in legislation. An example of this is minimum standards on non-financial reporting by EU companies, proposed by the European Commission on April 16, 2013.^{ixvii} At the time of writing, the final text of the legislation is being debated by the European Parliament and the Council of the European Union (the two co-legislators). As this report shows, it is critical that this legislation is robust enough to provide investors with the disclosure they require to assess material ESG risks and opportunities.

Transparency is also important for investors, in order for them to demonstrate to beneficiaries what (if anything) they are doing on ESG Engagement. Beneficiaries and other stakeholders have the right to understand what the investor is doing and how it is being done. Transparency on the investor side can be based on disclosure of Responsible Investment and engagement policy by asset owners and asset managers, or national initiatives such as the UK Shareholder Stewardship Code. In some markets, such as France, it is also mandatory for certain investors to disclose the outcome of their shareholder voting activity. For retail investors, the European Commission published a legislative proposal on July 3, 2012,^{ixviii} which includes mandatory disclosure in a Key Information Document (KID) on whether a fund takes into consideration ESG objectives in its fund management, inter alia because “information about non-financial aspects of investments can be important for those seeking to make sustainable, long-term investments.”^{ixix}

4.1.2. Technical Barriers

Beyond transparency, there are also barriers to engagement in the chain of financial intermediaries. Some of these can be addressed through legislation, and some need to be solved by the industry itself. These are collectively referred to as technical barriers in this report.

In general terms, to facilitate communication between shareholders and companies, companies should be able to identify the ultimate owners of shares and investors should be able to identify other investors in the company. This can be challenging in some markets, as shares are often held in custody accounts that hide the identity of the ultimate investor, or there is no obligation to publically disclose ownership records unless it crosses a certain threshold. Identifying shareholders is useful for companies, as they increasingly seek out responsible and long-term investors because they are seen as a more stable ownership partner than short-term traders. In addition, public ownership lists can help shareholder identify potential partners for collaborative engagement with companies.

This report has shown the importance and impact of collaborative engagement. However, in certain markets impediments to collaborative engagement exist, due to rules on acting in concert. For example, in the EU differing rules on acting in concert can create uncertainty for investors who collaborate on engagements.

There are also barriers in the share voting process, especially on a cross-border basis. While this is

not the central thesis of this report, it is worth noting because this is an area where legislators can have an impact. For example, the European Union greatly improved the legislative provisions of shareholder rights through the Shareholder Rights Directive in 2007, which included provisions such as a mandatory record date and disallowed the practice of share blocking in national legislation. However, evidence suggests that more can be done to facilitate voting in the EU as blocking of shares and other barriers still exist in practice.^{lxx}

Other technical barriers also exist, but these are probably the most common. However, as noted, some of these barriers are internal to the industry. These can be addressed best through constructive cooperation and by amending the contractual relationship of intermediaries rather than through legislation. In other cases, legislation may be needed to impose standards or clarify uncertainties.

4.1.3. Behaviour

As noted above, the second main objective with engagement is to change company behaviour. As legislating behaviour is very challenging, the focus of policy makers should also be in the field of setting minimum standards. Examples of this can be legislation on corruption, workers' rights, emission standards, environmental footprint of products, energy use, diversity of boards, executive remuneration, etc. There are an almost unlimited number of corporate and product standards that can define the minimum level of corporate behaviour.

Beyond the minimum standards, investors' opinion of appropriate corporate behaviour is more likely to diverge. Some may expect companies to adhere to OECD Guidelines, and some do not. This is where the onus is on investors to build a case for behavioural change through engagement, and represents the limit of legislative influence of behaviour.

In essence, the role of the policy maker is to allow the investor to do their job, which in this case is to exert appropriate oversight over companies in order to avoid misbehaviour. Investors are best able to do their job if they have access to the necessary information in order to perform their monitoring and analysis, and if they are not impeded in implementing the oversight by technical barriers.

4.2. The Future of Engagement

So far this report illustrates an overview of ESG Engagement practices in Europe and the different approaches to engagement that exist among investors. Before concluding, Eurosif gives a few experts and thought leaders the opportunity to share their personal view on the current state of ESG Engagement in Europe and what the future of engagement will bring.

Rients Abma – Executive Director, Eumedion

We see a tendency towards more ESG Engagement. This has been stimulated by three factors. First, demands from clients, and beneficiaries, companies and society at large (interested in e.g. remuneration policies, high profile takeovers, etc.). Second, increased awareness amongst institutional investors that engaged share-ownership will result in a better reward-risk profile of the investment portfolio. And third, the 'birth' of Stewardship Codes, principles, best practices and guidelines, developed by the United Nations (Principles for Responsible Investing; look at the increasing number of signatories), in the UK (look at the increasing number of signatories of the UK Stewardship Code), the Netherlands, South Africa,

India and by EFAMA. However, I would like to emphasise that the quality of engagement is more important than the quantity (number of 'engaged' institutional investors and number of meetings with listed companies).

Partly as a result of the financial crisis, costs at asset managers are under pressure and will remain so for the foreseeable future. I continue to believe that what matters is not merely the quantum of resources applied, but the way they are applied. Greater integration of portfolio management, investment decision making and strategic and ESG judgement could enable more to be achieved with the same resources. This is a question of business culture, however, it is not a change that can be achieved through legislation. The role of asset owners, such as pension funds, is critical in this. Since these are the clients of fund managers, they ought to be able to determine the investment and ESG approach.

Dr. Rory Sullivan, Strategic Advisor, Ethix SRI Advisors

There is clear evidence that well-designed investor engagement programmes underpinned by credible business case arguments can deliver real changes in corporate practice and performance. The challenge for investors is what to do in situations where the short-term business case for action is not clear cut, but where there is a compelling longer-term case for action; examples include the pressures created by climate change and resource scarcity. This will require investors to broaden their focus from operational efficiency and management-related issues, and to pay much more attention to how sustainability-related issues are being addressed in corporate strategy and in capital investment decisions.

Claudia Kruse – APG

The past decade has seen engagement activity grow tremendously. As its scope extends further I expect three areas to bear greater prominence:

- **Private markets:** More investors are engaging with their private market investments on ESG issues. Industry associations and asset-class specific ESG guidance, such as the ESG Disclosure Framework for Private Equity, will be increasingly important in advancing ESG aims and encouraging collaboration.
- **Standard-setting:** The Global Real Estate Sustainability Benchmark (GRESB) has shown how investors can jointly drive change across an entire industry. Setting a global sustainability standard has created comparability desirable for other sectors, too.
- **Public policy engagement:** As discussions over long-term investing, climate change, integrated reporting and the future of pensions and financial markets at large evolve, investors will need to find increasingly meaningful ways to engage with public policy.

I believe that we will see more collaboration among investors both in public and private markets. More and more engagement will be conducted in conjunction with and/or by portfolio managers to capture the value of engagement for investment decisions, in my view.

Karina Litvack, Head of Governance & Sustainable Investment, F&C Asset Management (2001-2012)

This report's deep dive into the 'what, why and how' of shareholder engagement is very welcome, indeed long overdue. As reform has swept across the regulatory, corporate and banking

arenas in the wake of the crisis, the one sector that has got off remarkably lightly is the Buy Side. Yet investors were largely compliant and complicit, preferring to focus on narrow aspects of corporate performance while neglecting systemic and long-term risk factors. Much as excess leverage insinuated itself into the financial system, wringing unprecedented value destruction, so broader ESG risks, chief among them climate and biodiversity-related, threaten our ability to preserve and generate wealth over time. Enlightened, patient and constructive investor engagement, as detailed in these pages, holds the key to making this right.

Dominique Biedermann, Executive Director, Ethos Foundation

Ethos observes that in Europe, more and more institutional investors consider that constructive dialogue with companies is paramount to carrying out their stewardship duties. Engaging in dialogue on ESG topics is an integral part of socially responsible ownership. It allows regular and long term communication between shareholders and the investee companies' board and management. In a long term value creation perspective, engagement will become more intensive in the future, in particular as it is perceived in Europe as a means to avoid confrontation. A coordinated approach in form of collaborative engagement is also expected to develop. When investors get together to engage with companies, they can benefit from synergies and available resources are used optimally, both for the investors and the companies.

Philippe Desfossés, Director, ERAFP

As underlined by Eurosif's last report on responsible investors' practices, ESG engagement and voting is growing in Europe. SRI strategies (best-in-class, exclusion, thematic, engagement, etc.) used to be rather exclusive and very different from one country to the other: Nordic countries were famous for blacklisting; the British have been engaging with companies for many years; and the French were known for their best-in-class preference. With the maturation of collaborative and transnational engagement initiatives (PRI Clearinghouse, IIGCC, etc.) and lobbying entities (ICGN, Eurosif, CDP), responsible investors have gotten to know each other better and have begun to understand the advantages of each other's SRI strategies. Engagement has most certainly benefited from these developments, as it is easier and more powerful for a group of investors to engage than for a single investor to do so.

We hope that engagement will become one of the pillars of all responsible investment strategies. We believe that engagement is all the more efficient if the investor has previously defined a robust SRI policy and has coherent SRI management processes in place. Indeed, dialogue with a company appears to be more fruitful when the investor has previously carried out in-depth ESG analysis of a company and its competitors and when the investor is able to show that its investment decision making process already integrates these issues. In addition, engagement amplifies the impact of a best-in-class approach and helps to align companies' business strategies with the overarching goals of sustainable development. In other words, ERAFP considers these approaches to be complementary.

We sincerely hope that engagement will become more global in the future. The Investor Statement on Bangladesh – an initiative coordinated by the US Interfaith Center on Corporate Responsibility that brought together a wide range of North American and European investors (representing over USD 3.1 trillion of AUM), including ERAFP, to engage on global supply chain issues in the wake of the Bangladesh clothing factory disaster in May – would be a laudable example to follow.

Conclusion

This overview of ESG Engagement practices in Europe demonstrates that active engagement has the potential to deliver value by generating profits, reducing risks and negative ESG externalities, encouraging better business practices, changing ethical behaviour and improving reputations. The type(s) of value(s) depends on your aim(s) as an investor.

Shareholder stewardship in general, and ESG Engagement specifically, can be considered an integral part of the investor toolbox for managing risk, advancing ethical values or international norms, and contributing to more sustainable companies. It is a long-term process that requires a structured approach and patience. It can also be resource intensive, which is why few investors engage with all the companies in which they invest, but rather choose to focus on where engagement can have the most impact.

Like all of the SRI strategies, ESG Engagement has a place and a purpose. This is why most ESG Engagement is combined with other SRI strategies in order for investors to be able to pursue multiple goals simultaneously with their investments. The finding that it is common to combine ESG Engagement with other strategies also supports evidence that ESG Engagement is becoming more integrated into the traditional investment process.

While ESG Engagement is growing, it still has a significant way to go to become mainstream. Growth can come from two sources: new investors adopting an ESG Engagement policy, and investors already active in ESG Engagement extending their activities to a greater proportion of their portfolio. The key to increasing the amount and improving the quality of ESG Engagement is showing to asset managers, asset owner and beneficiaries that ESG Engagement is not as difficult as often perceived and has the potential to deliver value creation. Beyond this, growth can also come from clarifying the concept of fiduciary duty, and removing impediments to engagement in legislation.

The key takeaways from this report are:

- Investors can best achieve positive results from ESG Engagement through constructive, strategic and targeted engagement based on sound business analysis;
- Policy makers can use a smart combination of legislation and initiatives to reduce barriers and costs to engagement, improve transparency by companies and investors and therefore better achieve some of their overall policy goals;

Companies can build a constructive relationship with investors by enabling dialogue at board and management level, and by improving disclosure of material ESG information.

End notes

- i** Available at: <http://www.eurosif.org/research/eurosif-sri-study>.
- ii** These are often referred to as institutional investors or professional investors. They are distinct from individual retail investors or non-professional investors.
- iii** In some cases, the investor may also engage without holding an economic stake. See the ASN Bank case study on page 38 for an example of this.
- iv** Shareholder action at general meetings can be proactive in the case of attending the meeting and posing questions directly to management, as will be discussed. Shareholder can also lodge shareholder proposals at general meetings, but this is very rare in Europe especially on ESG matters.
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- xxv** FRC, UK Stewardship Code, <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx>
- xxvi** Eumedion is an independent foundation, managed by representatives of participants, whose objective is to maintain and further develop good corporate governance in the area of the responsibility of asset owners and asset managers established in the Netherlands.
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Glossary and Abbreviations

Asset manager	Organisation or individual managing investments on behalf of a client.
Asset owner	Owner of investments managed by asset manager.
Best-in-Class	Approach where leading or best-performing investments within a universe, category, or class are selected or weighted based on ESG criteria.
Engagement and voting	Engagement activities and active ownership through voting of shares and engagement with companies on ESG matters. This is a long-term process, seeking to influence behavior or increase disclosure.
ESG	Environmental, Social and Governance
ESG Integration	The explicit inclusion by asset managers of ESG risks and opportunities into traditional financial analysis and investment decisions based on a systematic process and appropriate research sources.
Exclusions	An approach that excludes specific investments or classes of investment from the investible universe such as companies, sectors, or countries.
Institutional investor	Large professional investors such as pension funds for instance. In this study, institutional investors may comprise asset managers and asset owners, to the extent the latter manage internally a part of their invested assets.
Norms-based screening	Screening of investments according to their compliance with international standards and norms.
PRI	Principles for Responsible Investment
Shareholder Stewardship	An activity that aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole. (Source: FRC)
SIF	Sustainable Investment Forum
SRI	Sustainable and Responsible Investment
Sustainability themed	Investment in themes or assets linked to the promotion of sustainability. Thematic funds focus on specific or multiple issues related to ESG.
UNGC	United Nations Global Compact

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EUROSIF, the European Sustainable Investment Forum, is the leading European membership association whose mission is to develop sustainability through European financial markets. It was founded in 2001 and works as a partnership of the national Sustainable Investment Forums (SIFs) and with the support and involvement of Member Affiliates. The eight national SIF members of Eurosif are based in France, Germany, Italy, the Netherlands, the UK, Belgium, Spain and Sweden. Eurosif's Member Affiliates include institutional investors, financial services providers, academic institutes and NGOs.

Membership of Eurosif is open to organisations with a commitment to SRI at a European level. A current list of Member Affiliates is published on www.eurosif.org.

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