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Voting & Engagement: Pillars of sustainable investing

CANDRIAM ACADEMY
INVESTORS FOR TOMORROW

Voting and Engagement: There is no sustainability without stewardship

With sustainability a core topic for the investment community, the impact of Voting and Engagement is ever more apparent.

Investors are increasingly integrating Environmental, Social and Governance (ESG) considerations into investment decisions. These can be implemented in portfolios through either risk-focused **negative selection approaches**, such as exclusions based on international norms and controversial activities, as well **as positive selection approaches**. These aim to identify the best ESG performers not only in terms of minimizing risks, but also in terms of ESG **opportunities** and **impact**.[1]

The buck does not stop here. Being a truly sustainable investor is not just about identifying and investing in the right issuers. What comes *after* is just as important. In our view, those who reduce sustainable investing to a binary choice between 'perfectly sustainable' and 'not sustainable' issuers are missing the point. They are failing in their roles as asset stewards. Such a binary approach is not in line with today's social, environmental and economic realities.

Indeed, Sustainable investing is also about *accompanying* issuers in the improvement of their environmental, social and governance practices. Being an investor confers certain rights and bestows influence, in particular through Voting and Engagement. Being an active investor and steward not only influences the behavior of issuers, it helps investors gather data and insights which can improve ESG investment analysis and contribute to alignment with new and future sustainable investment regulation. This sharing of information can be two-way, or even collaborative, among issuers and investors who wish to share information, share best practices, and limit negative ESG impacts.

1 See the Candriam Academy Guide, Positive and Negative Approaches

Monitoring the monitors

Investors need to pay close attention to the Voting and Engagement practices of the asset managers they appoint. Investors who wish to fully leverage their voting rights and engagement potential can do so by exercising these rights themselves. However, to be effective, these activities are time- and resource-consuming. Most investors choose to delegate Voting and Engagement to their asset managers or to specialized external service providers, in effect agreeing to the investment manager's policies (but see *Analyzing Voting Practices, Voting Policy*, page 7).

This guide aims to help investors develop their own frameworks for evaluating the Voting and Engagement practices of external providers, or to develop their own set of practices.

How great is the task?

How many questions must asset managers evaluate in a voting season?

Consider an index fund.

- ***The MSCI Europe equities index consists of more than 400 companies, averaging an estimated 12 resolutions to be voted at each annual general meeting.[2] Do the math!***

And elsewhere...

- *In the US, the S&P 500 index consists of – you guessed it – 500 companies.*
- *The MSCI World index of developed markets includes more than 1,500 companies, while the MSCI Emerging Market index contains more than 1,300 companies. That's rather a large sum.*

2 Candriam estimate, based on 1,927 meetings voted globally in 2021.

Definitions:
A shared vocabulary

As for many areas of sustainable investment, these notions can at times lack clarity or agreement.

Stewardship

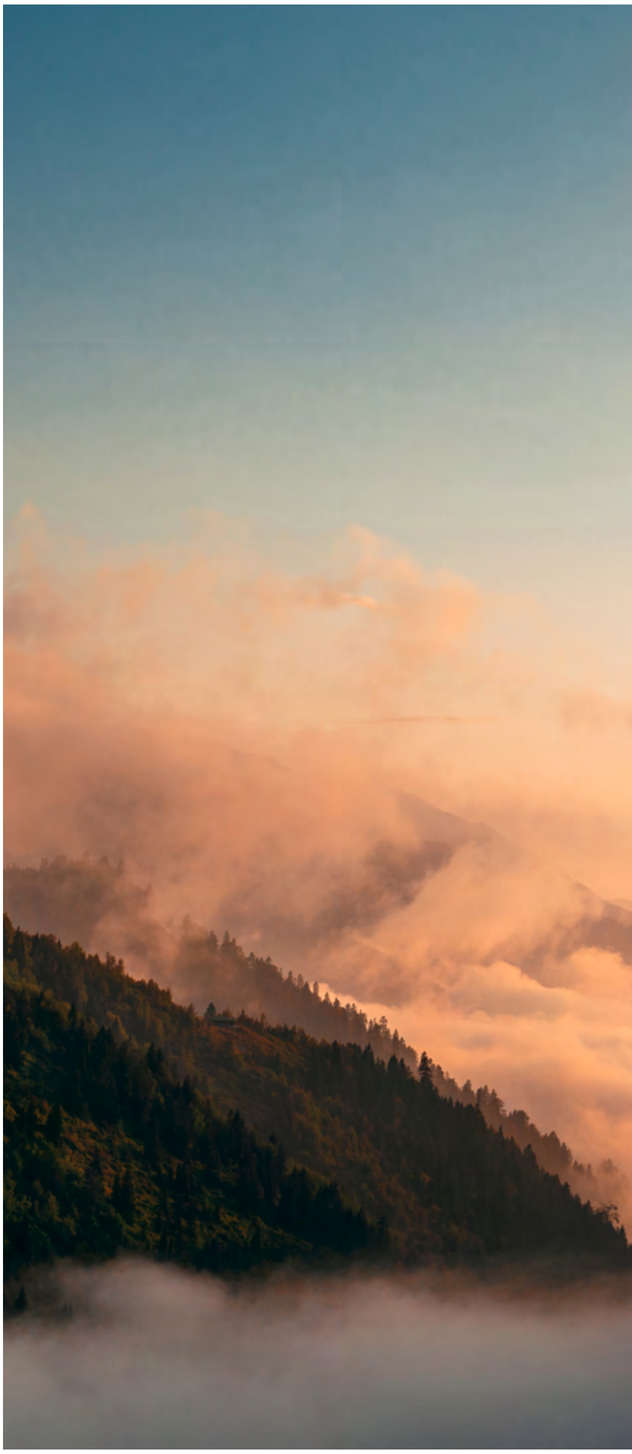
The notion of Stewardship includes Voting and Engagement, but is much broader. Investment stewardship encompasses "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society" (UK Stewardship Code, 2020). Thus, Stewardship covers all elements of the investment management process.

Voting

Primarily relevant for equity investments, Voting is the exercise of owners' voting rights for/against management and shareholder resolutions, directly at shareholder meetings or sometimes by proxy. In some cases, bondholders and others may vote, for example when an issuer wishes to change the terms of an indenture.

Engagement

Interactions between the investor (or their representative) and current or potential investee companies or countries, particularly on ESG issues and relevant strategies, fall under the concept of Engagement. This may be through direct dialogue or participation in collaborative initiatives with other investors, but also includes Voting. Annual Meetings are a legitimate forum for exchange on such matters.



Regulation

Regulation designed to channel assets into more sustainable investments is rising, with Europe in the lead. These new regulations also encourage active Voting and Engagement practices.

SRD II

The updated version of the EU's Shareholder Rights Directive II (SRD II) brought a number of new rights and obligations for shareholders, companies and asset managers into effect in 2019-2020. For example, *asset managers must disclose how they have exercised their voting rights, or explain why they have not exercised them.*

Other objectives are to encourage long-term shareholding, reduce short-termism, and discourage inefficient quarterly targets. Much of the updated directive is dedicated to the role of each party in the voting process, and is designed to facilitate the exercise of voting rights and the transparency of votes. Standards have been established for, among others, custodians, proxy advisers, and issuers. Notably, the directive imposes a "say-on-pay" on corporates, granting shareholders of EU-based companies an annual vote on the remuneration of directors, although the details vary by country.

Taxonomy, SFDR, and CSRD

The **EU Taxonomy** sets out criteria and thresholds under which various economic activities can be labelled 'sustainable'. A central issue with this framework remains the lack of data.

Voting and Engagement play a dual role with regards to data and reporting – and globally, not just in the EU. First, Voting and Engagement can be employed to encourage companies to provide more disclosure, and second, to enhance direct communication between investors and companies to help make more informed investment decisions. Signatories of the UN PRI agree to seek ESG disclosure by the entities in which they invest (third principle). While helpful in pushing for the necessary data for this regulation, remember that Engagement is primarily a tool for investors to influence and change company *ESG practices*.

The **Sustainable Finance Disclosure Regulation** (SFDR) is based on the principle of 'double materiality'. That is, investors must examine both the sustainability risks to which investments are subject (also called 'financial materiality') as well as the potential Principal Adverse Impacts (PAI include a company's Greenhouse Gas emissions, or carbon footprint) that these investments might have on the environment and society. Voting and Engagement play a key role in understanding and managing these risks and impacts.

The **Corporate Sustainability Reporting Directive** (CSRD) aims to accelerate the disclosure of extra-financial data by companies, but its full effect is only likely to be seen from 2024 onwards – that is, when reporting 2023 results. It applies only to EU companies. The fact that CSRD will be fully effective only in a few years from now, and will apply only to EU companies, underscores the importance of Voting and Engagement as an additional tool to encourage companies -- including those outside the EU -- to improve disclosure of extra-financial data.

Environmental and Social Resolutions

According to the non-profit group ShareAction, in 2021

- ***The world's six largest asset managers ''routinely ignored'' advice from their voting advisors.[3]***

- ***European asset managers were the most active in voting for environmental and social shareholder resolutions.[4]*** *Almost every manager in the top half of this voting ranking was Europe-based.*

Many of those asset managers who failed to exercise client votes are members of Climate Action 100+, and many are signatories of the UN Principles of Responsible Investment (PRI).

3 There may have been some valid reasons. There have been significant changes in the details of management-sponsored Say-on-Climate resolutions between 2021 and 2022, and proxy advisors significantly strengthened their level of analysis of Say-on-Climate resolutions between 2021 and 2022. For our own detailed explanations, see Candriam's documents, 2022 Mid-year Voting report, and Who would vote Against a Climate Resolution?

4 ShareAction. *Voting Matters, 2021. Are Asset Managers using their proxy votes for action on environmental and social issues?* December 2021. ShareAction-Voting-Matters-2021.pdf. Accessed 18 July, 2022.

Voting

Shareholder votes are rich in consequences. Consider the typical annual request for the discharge of personal liability of managers and directors. While the legal implications vary, the 'discharge' is generally received as recognition of confidence and trust in management. This makes it difficult for shareholders to hold management accountable if a breach is discovered later.

ESG – the Big Three of voting topics

Certain items may be regularly put to a shareholder vote. The most frequently recurring items fall under **G**overnance, such as (re)election of directions or remuneration.

Votes on **E**nvironmental and **S**ocial issues are increasingly common and often highly publicized, even if in number they remain limited at the moment. More frequent topics include energy transition, the 2°C scenario, or the gender pay gap. When voting, it is important to know and understand the company's current practices, any arguments against the resolution, the materiality of the issue, and the cost and/or feasibility of implementation.

Analyzing voting practices

When reviewing the voting practices of asset managers, we suggest investors consider three broad categories.

- ***Voting policy***

Prior to delegating voting power to the asset manager or others, the investor should fully understand the voting policy of the asset manager, not only on standard voting questions such as director elections, remuneration, capital increase or auditor renewal, but also on environmental and social topics, and how the ESG practices of the company may influence the shareholders' vote on, for example, the election remuneration of directors. Alternatively, if the investor charges the asset manager to execute its own specific or custom voting policy, the details and intent must be clearly defined, preferably taking into account regional differences, and regularly updated. (For example, it is not yet relevant to expect 40% of the board consist of women directors in regions where the majority of local boards are 100% male.)

• *Resources and preparatory analysis*

For the voting exercise to be meaningful, it is important to review the details of each resolution on the agenda of each company general meeting, or extraordinary meeting. Does the decision maker -- asset owner, investment manager, or external advisor -- have the resources and experience to do so? These resources can be internal or external, such as the support of a proxy advisor.

Aligning voting with investment strategy and opinion on the issuer is key, which implies a well-structured and coordinated process between different parties.

• *Voting track record*

The voting record should be transparent. How many Annual General Meetings has the asset manager voted in past years? How many votes were cast, and on which principal items did the asset manager oppose the recommendation of management? Does the asset manager ask questions, make public statements ex ante or during the annual meetings, and/or submit resolutions? Voting issues have changed dramatically since the outbreak of Covid, as have voting practicalities, with more meetings held virtually. How has the asset manager adapted voting policies to the post-Covid world?

Great importance should be given to this level of transparency and to the capacity of the asset manager to review the last voting season with a keen eye, highlighting emerging new topics and providing examples of how more sensitive resolutions are identified and treated.

Get out the vote!

According to the non-profit group ShareAction, in 2021

- ***10% of the world's largest asset managers voted on fewer than 40% of the resolutions for which they were representing their clients.[5]***

- ***5% voted on fewer than 20% of the resolutions.***

Fortunately, at Candriam we cast vote 92%[6] of our possible votes.

5 ShareAction. *Voting Matters, 2021. Are Asset Managers using their proxy votes for action on environmental and social issues?* December 2021. ShareAction-Voting-Matters-2021.pdf. Accessed 18 July, 2022.

6 92% of open-ended equity funds, by AuM, as of year end 2021. Candriam Annual Engagement and Voting Report, page 67.

Engagement

Through Engagement, investors or their delegates interact with current or potential investee companies or countries on ESG issues. To be effective, Engagement must be fed by EGG analysis which highlights issuer weaknesses, best practices, paths for improvement, and of course, Engagement outcomes which loop back to the ESG analysis. Engagement priorities, in turn, can be set with the of the ESG analysis and integration.

• Influence corporate practices on ESG issues

Investing sustainably is not simply Yes/No choices, but more about contributing to continuous improvement. Investors should feed a virtuous circle of communicating best practices to companies.[7] Engagement should encourage issuers to adopt to recognized standards and best practices, in turn facilitating their better anticipation and management of ESG risks and opportunities. Engagement is also an important tactic in the toolbox of EU investors in their effort to manage Principal Adverse Impacts (PAIs) and implement the Do No Significant Harm (DNSH) and Good Governance principles under EU regulations.

• Support investment decision-making

The information gathered can enrich both the ESG and the financial analysis, leading to more informed investment decisions.

Engagement activities can involve other stakeholders, such as employee unions, industry federations, or nonprofit organizations. These groups can offer new ideas, aid in implementation, and sharpen sector knowledge.

• Encourage improved ESG disclosure

Transparency in general, and collection and reporting of extra-financial data in particular, is an important and ongoing issue in sustainable investing. A key focus of Engagement is to encourage transparency by issuers.

7 Continuous improvement is fundamentally included in the United Nations Principles of Responsible Investment (UN PRI).

Direct dialogue

Direct Engagement between the investor (or their asset manager) and the issuer requires expert resources and is time consuming. To optimize efficiency, it can be useful to prioritize on a pre-determined set of well-defined themes.

Collaborative initiatives

Collective Engagement allows investors to pool their weight, either as owners or creditors, to support strong and urgent changes in practices, promote key initiatives and encourage transparency. Collaborative initiatives can also play a role in anticipating and exploring new risks that are not yet well-understood, or well-regulated.

These collective efforts can also be particularly relevant for public/sovereign issuers such as a country, a group of countries, an international organization, where size of the issuer may make both access and influence difficult to obtain.

Collaborative initiatives can be effective and efficient...

- *With sovereign or public issuers, where access and influence may be difficult.*
- *With corporates, when individual dialogues have been unsuccessful*
- *When investors have a shared understanding of a topic, collective engagement can reduce reporting costs for the issuer and avoid responding to numerous similar questions – economy of scale for the issuer*
- *When investors need to contact numerous companies on the same topic – economy of scale both for issuers and investors*
- *When increasing media coverage is expected to raise public attention on the topic*
- ***Whenever greater leverage is helpful and a number of investors are of like mind!***

Voting, Engagement, and Investing go hand-in-hand.

Good stewardship of investments integrates Voting and Engagement into the investment process. Voting and Engagement experts should collaborate closely with portfolio managers and analysts. ESG analysis is the prerequisite for Voting and Engagement, while Voting and Engagement in turn inform the ESG analysis and the full investment function.

Voting and Engagement should not occur in isolation. They should be aligned, and inform one another. Resolutions and voting outcomes at AGMs may trigger post-AGM dialogue, especially when views diverge. In turn, dialogues with an issuer which had been involved in a controversy, can help determine whether management has taken meaningful steps towards improvement – and can help shape subsequent votes.

Voting and Engagement are necessary for truly sustainable investing, core contributors to risk mitigation, and sources of long-term value creation. Investors evaluating asset managers to which money is entrusted, are well advised to look not just on the quality of financial and ESG analysis, but also at that of Voting and Engagement.

The Covid-19 pandemic has underscored the importance and scope of Engagement and Voting. Environmental, social and governance issues have been highlighted even more by the crisis and have crystallized in dialogues with companies and in resolutions.

Exercise of Engagement and Voting rights enable investors to play an active role in the transition to a fairer and more sustainable world.

10,000 members

5 years

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+17,000 hours

of accredited training

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