Sustainable investing

Education primer: ESG engagement equities

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Rachel Whittaker, CFA, Analyst; Melissa Spinoso. Andrew Lee, Head of Sustainable and Impact Investing, andrew.lee@ubs.com; James Gifford

• An ESG engagement equities approach provides exposure to equities of companies that would benefit from specific identifiable environmental, social and governance (ESG) improvements, with the investor proactively lobbying and working with company management to drive positive incremental change.

• ESG engagement equities work best in concentrated portfolios where the investor can devote significant time and focus to each holding, seeking out companies that are particularly likely to be receptive to proactive investor involvement.

• While most SI equities strategies have limited potential to drive intentional, measurable impact in the underlying public companies, a highly active and targeted engagement (also known as advocacy) strategy is the only avenue to pursue the subset of SI that we define as “impact investing” in listed equities.

Our view

Sustainable investing (SI) is an investment philosophy that can be applied to a wide range of asset classes. It seeks to achieve competitive portfolio risk/return characteristics comparable with a traditional approach while also having a positive effect on the environment and society and/or aligning investors’ portfolios with their goals and values.

ESG engagement equities represents an active equity strategy, investing in equities that present the potential for both upside financial returns and specific social and environmental outcomes through proactive and constructive engagement. Shareholder engagement is also known as shareholder advocacy, particularly in the US. This strategy is, in our view, the only way to pursue impact investing (defined as a specific subset of SI in which the positive social outcomes are intentional, measurable, verifiable, and additional) in listed equities.

Academic evidence suggests that successful ESG engagement can also lessen downside risk and enhance returns of targeted companies (e.g. Dimson et al, 2015, see also section below on performance).

This report is part of a series of short primers on key sustainable investing (SI) strategies. You will find more information on the client portal. You can also contact your advisor for assistance.

SI strategies are investment approaches defined by UBS that target market rate returns as well as social and environmental objectives. Each strategy is distinct in how it incorporates sustainability into the investment process, in its investment characteristics, and in how it seeks to address one or more of the primary objectives of sustainable investing:

• aligning investments with long-term sustainability goals, or personal values
• potentially improving portfolio risk/return characteristics by incorporating environmental, social, and corporate governance (ESG) criteria into investment decisions
• achieving a positive environmental or social impact alongside financial returns.

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What are ESG engagement equities?
An ESG engagement equities strategy displays the following characteristics:

- Engagement is a – if not the – core element of its strategy, which seeks to achieve specific outcomes and lead to concrete changes (identified ex-ante) in corporate behavior.
- The fund manager targets companies with significant potential for ESG improvement, including those that have not had investors previously raise sustainability issues like emerging market companies, small/mid-cap developed market companies and those with developing country supply chains.
- The fund manager works with the companies it invests in to promote change initiatives that are expected to have a demonstrable impact and the potential for a related earnings benefit and a higher valuation multiple. More confrontational shareholder activism may be warranted in circumstances when a company ignores the valid concerns of its stakeholders.
- To support engagement and impact claims and provide investors with transparency, the strategy must be underpinned by robust systems that develop, implement, monitor and report on engagement topics, company targets, engagement goals and milestones, outcomes and attribution.

An engagement equity approach can in theory be applied to any region, sector, or size of company. The ideal approach from a sustainability perspective would be a very targeted portfolio with a highly active engagement strategy that seeks to maximize sustainability benefits. However, taking this to the extreme interpretation would imply an ultra-concentrated portfolio focused on emerging markets where sustainability challenges are greatest. The potential for impact and alpha generation would be higher, but so would be the volatility and risk relative to a benchmark.

In practice, in order to build commercial, scalable investment products that are accessible to most investors, most engagement equities fund managers will trade off some impact potential in order to construct a portfolio that broadly aligns with a conventional benchmark, e.g. MSCI World, but still has the potential to achieve meaningful impact.

Can ESG engagement equities be labeled impact investing?
A leading investor motivation for investing sustainably is to have a positive impact on society and the environment using investment capital. Typically, private market solutions have the potential to generate the greatest impact, as the long term orientation and multi-year capital lock-up provides fund managers significant flexibility to meet the UBS definition of impact investing. UBS defines impact investments as those that finance companies, organizations, and funds with the intention of generating social or environmental impact alongside a financial return. In practice, we consider three criteria alongside the generation of desirable financial returns to delineate what qualifies as impact investing: a stated and explicit intention to generate positive social and/or environmental impact in addition to sustainable financial performance; that the outcomes of the investment be tied to specific metrics, and measured against a base case or benchmark; and verification that the invested capital itself is positively correlated with the intended outcome. We also look for additionality - measured against a business-as-usual or base
case scenario, would the capital have been allocated, or the social/environmental impact created regardless of the investment (UBS, 2016). This definition aligns with that of the Global Impact Investing Network (GIIN).

Achieving these criteria, particularly additionality, through listed equities is challenging. Additionality refers to the question of whether the capital, when measured against a business-as-usual or base-case scenario, would have been invested or the social/environmental impact created. Simply owning shares of listed companies, regardless of how high their ESG ratings or how impactful their products and services, is insufficient to demonstrate additionality. Listed shares are bought and sold without the capital directly being injected into the underlying company. Typically, in our view, the more liquid the market, the lower the potential for any investor or fund to demonstrate impact simply by owning or not owning certain equities.

One way of achieving positive impact in listed markets is by using active shareholder engagement to incrementally alter the behavior of targeted corporations for the better. Such engagement on ESG issues, either directly with company management or by filing shareholder proposals, has been proven to change corporate behavior.

For example, according to data compiled and analyzed by Ceres, of the 779 climate-related shareholder proposals filed from 2013 to 2018, 41% were withdrawn after investors and the companies in question agreed that the latter had made or had pledged to make sufficient progress in this area. Of those that went to a vote each year, 28% of the shareholders, on average, supported the proposals (see Fig. 1). We believe that the publically reported benefits to society and/or the environment represent the minimum that has been achieved through engagement, and the true figure may be higher, as any behind-closed-doors shareholder efforts that resulted in better company practices may not have been disclosed.

As engagement strategies intentionally target specific social and environmental outcomes in addition to financial value creation, we consider them to be impact investing strategies.

**Performance considerations**

A number of studies have documented that following ESG engagement strategies can lead to outperformance. Hoepner et al. (2018) studied data from 682 engagements across 296 targeted firms by a large and influential institutional investor from 2005 to 2014. The investor’s approach involved direct, confidential dialog with company management and each engagement took, on average, 34 months to complete.

The study identified meaningful differences in the downside risk of engaged firms to a set of matched control firms not targeted during this period. Value at risk (VaR), for example, was 20% lower for engaged firms. The risk-reduction effect of ESG engagement only occurred, interestingly, when the efforts succeeded, that is, when the company responded to investor demands with real action.
Efforts focused on governance, strategy and risk topics seem to have had the largest effect, while those directed at environmental topics did not seem to reduce downside risk unless combined with improved governance. Engagement on social and ethical themes had seemingly no effect at all.

Dimson et al. (2015) analysis of more than two thousand ESG engagements undertaken with 613 public US firms in the 1999-2009 time period is recognized as the most compelling empirical study to offer evidence on how successful ESG engagement leads to improved operating performance, profitability, efficiency and governance.

The study showed significant financial outperformance in the period following the engagement, documenting a positive size-adjusted abnormal return of 2.3%. For successful engagements the adjusted abnormal return one year after the initial engagement was 7.1%, and no market adverse reaction for unsuccessful ones was identified (See Fig. 2). The effect is more pronounced for efforts centered on corporate governance and climate change.

These studies underpin the view that successful ESG engagement can lessen downside risk and boost the returns of specific companies. But any causal link between specific engagement and financial results is difficult to establish. Companies are often engaged by a number of investors at the same time or approached by collective engagement, and company behavior is also influenced by other factors, such as unrelated management changes, and external ones like legislative changes. Engagement processes may also take years to have an effect, and changes in how ESG issues are managed can also take a long time to materialize.

The above-mentioned studies do not lead to the conclusion that portfolios featuring engagement strategies outperform or have lower risk. It largely depends on the quality of the engagement. Engagement is probably best viewed as an important element of being an active and responsible shareholder. It can be applied to any equity portfolio, and return and risk expectations should be in line with comparable portfolios that have the same strategy.

How to invest in ESG engagement equities

Investors wishing to achieve impact via ESG engagement in listed equities can choose either funds that explicitly target specific issues or funds offered by an asset manager with good ESG engagement capabilities applied across its entire fund family.

Targeted funds

To meet our criteria, targeted engagement funds must demonstrate intent and a measurable, verifiable and additional impact that results from their dialog and activism. This is certainly the case for a number of the most activist US socially responsible investment (SRI) funds that focus on this strategy as their key mission.

Larger firms are likelier to be targeted by activist shareholders, as they have greater exposure by nature, particularly if they have a strong brand. At the same time, these companies may have fewer incentives to make substantive changes unless the pressure exerted is intense and stems from multiple large shareholders.
A paper by Rehbein et al. (2013) hypothesized that smaller firms are more likely to respond to stakeholder demands and acquiesce to activists. However, their analysis sample did not support this hypothesis. Nevertheless, fund managers who want to attribute positive impact to their specific dialog and activism are likely to target smaller, potentially emerging market companies, where efforts by a single investor can make a major difference. This approach requires a very active management style.

**Proactive asset managers**
Since the choice of targeted funds remains limited, the investment vehicles of managers who position themselves as proactive in terms of engagement represent another option. These managers usually engage with companies based on the aggregate stakes held by the various investment vehicles they manage. These efforts are not necessarily associated with a single specific fund. Because they stem from the same overall asset manager though, they may well have a demonstrable impact. Engagement claims by the manager must be backed up by evidence that can be evaluated independently and with as much transparency as possible.

Fig. 3 contains a short list of questions that can assist investors in selecting ESG engagement equity funds.

**Key risks**
ESG engagement equities strategy must be underpinned by a conventional or SI equity investment approach, and as such the usual risks of investing in an equity portfolio apply to this approach. There are also a number of ESG engagement specific risks:
- **Resource-intensive process**: Funds that aim to attribute specific outcomes to their engagement must devote significant time to it. If a strategy seeks returns in line with traditional strategies, fund managers must have a focused approach and/or dedicated staff to ensure the process is not too resource-intensive.
- **Benchmark orientation vs. impact**: It is difficult for funds to pursue an active strategy that aligns closely with a benchmark. The performance of concentrated ESG engagement portfolios may differ significantly from that of a standard benchmark either in terms of region, site or sector, and result in portfolios with higher volatility than a conventional equity strategy.

**Social and environmental contribution**
Engagement or activism has increasingly been applied as a tool by alternative investment managers in the last two decades, while traditional institutional investors still tend to use engagement less as a proactive part of their strategy and more as a response to controversies, perceived underperformance or misaligned strategy at a company. It is typically very difficult to attribute any change achieved through this type of low intensity engagement, hence an ESG engagement equities strategy must, in our view, have proactive and targeted engagement at the heart of the investment process in order to ensure that the engagement is impactful.

According to the Global Sustainable Investment Alliance (GSIA) (2017), corporate engagement and shareholder action increased
41% between 2014 and 2016. The strategy has established itself as the third most popular worldwide, with more than USD 8tn assets under management. Europe accounts for 56% of those assets, followed by the US with almost 31% (GSIA, 2017). See Fig. 4.

**Fig. 5: Value creation mechanisms**

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<tr>
<th>Corporate side</th>
<th>Value creation dynamics</th>
<th>Investors</th>
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| • Clarifying expectations and enhancing accountability  
  • Managing impressions and rebalancing mis-representations  
  • Specifying the business context | Communicative dynamics | • Signaling and defining ESG expectations  
  • Seeking out detailed and accurate information  
  • Enhancing ESG communication and accountability |
| • Anticipating and detecting new trends related to ESG  
  • Gathering feedback, benchmarking and gap-spotting  
  • Developing knowledge of ESG issues and practices | Learning dynamics | • Building new ESG knowledge  
  • Contextualizing investment decisions  
  • Identifying and diffusing best practices |
| • Enrolling internal experts  
  • Elevating sustainability and securing resources  
  • Enhancing the loyalty of long-term investors | Political dynamics | • Advancing internal collaboration and ESG integration  
  • Meeting client expectations  
  • Building long-standing relationships |

Source: Principles for Responsible Investment (2018)
Some of the motivations to undertake ESG engagement identified by Eurosif (2013) and BlackRock and Ceres (2015) are: maximizing risk-adjusted returns, gauging the sophistication of a company’s strategy, understanding performance indicators, advancing ethical or moral considerations and understanding potential regulatory impacts and threats, among others.

O’Sullivan and Gond (2016) looked at how engagement strategies create additional benefits, interviewing 36 European institutional investors with a collective AUM of over EUR 6.4 trillion. They found that three mechanisms (communication, creation of new ESG knowledge and political benefits) help explain how companies integrate and improve their ESG performance, leading them to engage in long-term value creation and contribute to more sustainable societies. The Principles for Responsible Investment (2018) have summarized how these mechanisms are perceived from both the corporate and the investor angle (see Fig. 5).

The Sustainable Development Goals (SDGs) are a set of universal goals, targets and indicators defined by the UN in 2015. They cover social, environmental and economic issues that represent a latent challenge to the world (see Fig. 6). For this reason, the SDGs have become a framework increasingly referenced by investors who want to identify areas for engagement or structure reports based on engagement. Investing within an SDG frameworks can help achieve positive financial and environmental and/or social impact. For example, a strategy that leads to better health and safety standards in a garment factory could also raise productivity, which in turn increases revenue.

References

Fig. 6: The UN Sustainable Development Goals
17 Goals to be achieved by 2030

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UBS CIO Wealth Management (2016). Doing well by doing good