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The Importance and Possibilities of Active ESG-Ownership

- What is active ESG ownership?
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#2

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The Importance and Possibilities of Active ESG-Owners

Investors have in recent years engaged more with companies on sustainable issues to change their behavior and improve the long term performance[1]. The question is whether these engagements have actually been successful in achieving this. By reviewing recent research it is documented that these engagements have indeed improved sustainability and the financial performance.

Increasing relevance of active ESG ownership

In recent years, the perception of a company's role in society has changed among investors and within society. First, companies should change their focus from short to long term financial performance as well as being more responding to broader social challenges, including climate change. This also includes how to make positive contributions to society rather than only to shareholders. Companies inability to take these challenges into account could expose them to greater risk, because their business model could be considered non-sustainable by a growing number of stakeholders, customers and investors in the society. Ultimately, this could dampen their long term growth potential, e.g. through a higher cost of capital. Second, investors have taken a more active ownership for these societal challenges. Investors are not only exercising the right for voting on proposals at the annual general meetings. They are also engaging more directly with companies (management, board and committees) on concerning ESG issues to change company behavior and improve the strategy for long term growth.

This is not only a shift away from how economic theory has traditionally seen companies as purely profit maximizing entities in isolation from any societal responsibility, see Friedman (1970). It is also a shift in the way traditional institutional investors (mutual funds, pension funds, investment managers etc.) have now begun to interpret their fiduciary responsibility for the beneficiaries. The beneficiaries are often, for instance in case of pension funds, private investors and customers. Long term financial performance of the companies in the funds should also be consistent with a sustainable future that the beneficiaries themselves are part of. In many ways it is a shift away from a society where only governments are taking a responsibility to correct for negative externalities from companies on society (e.g. by imposing taxes) as in Pigou (1920), to investors in companies taking a larger responsibility for this as well. The regulation has also shifted in favor of more emphasis on sustainability issues.

Active ESG-ownership has therefore become increasingly relevant for all investors.

Divestment as method to improve sustainability

An obvious question for investors to ask is if they could change the company behavior and improve sustainability by simply divesting from companies with concerning ESG issues. Traditional economic reasoning would argue, that if a sufficient large number of investors neglect or divest from a stock, then the price of it could decrease due to limited risk sharing and ultimately the company could face higher cost of capital, see Merton (1987). Divesting could therefore, at least in principle, have a positive effect on sustainability, because higher cost of capital for non-sustainable companies would make less non-sustainable projects profitable and hence launched in society.

While this reasoning holds in principle it is presumably less likely that divesting could improve the sustainability in practice. First, divesting precludes investors from changing the company behavior since only investors can vote, make proposals or engage with the company in any meaningful way, see PRI (2018a). By not divesting the investors also keep the opportunity to discipline management through (future) interactions, see Edman and Manso (2011). Second, due to their large holdings in the companies, it could often in practice be difficult to divest without driving prices further down and therefore suffer some further losses. In addition to this, many institutional investors have indexed a large portion of the funds, which could effectively constraint them from divesting a significant number of companies without affecting the risk

[1] Larry Fink's "2018 Annual Letter to CEO" is a prominent example of this, see Fink (2018).

and return properties of the funds; see Gillian and Starks (2000). Third, the decrease in prices relative to fundamentals[2] may lead other types of investors (e.g. value investors) to buy the stock and by this preventing the price to decrease much. Forth, if the objective is to improve the sustainability (in companies and society) then divesting means the investor clientele after the divestment will be even more averse to ESG improvements. Fifth, research suggests that companies with lower ESG scores also have higher cost of capital, see Clark et al (2015), but this may not necessarily prevent them from being attractive enough for a sufficient number of investors and be able to continue the (non-sustainable) operations. The Tobacco industry seems to be an example of this. These stocks have for an extended period of time been excluded by many investors but have been able to continue operating and even outperform the market.

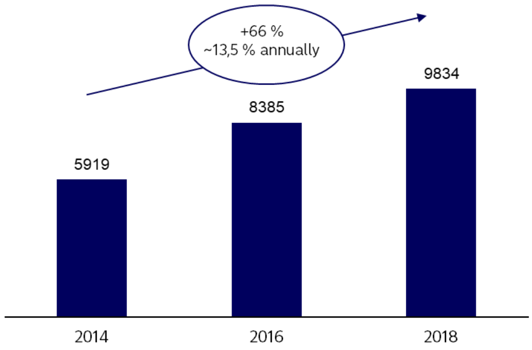
The considerations above does not mean institutional investors will not find it beneficial in some cases to use divestments for other reasons. In relation to sustainability issues, it could ultimately be used if an engagement has proven unsuccessful in documenting any progress and if the ESG issues are sufficiently critical. Other reasons for divesting could include a reduction in investment risk or to improve commercial success depending on the customer expectations.

If the objective with divesting from companies is to change company behavior and improve sustainability in society then divesting seems to be less effective in achieving this. This could also explain why active ESG-ownership has gained popularity among investors as an alternative route to change company behavior.

Active ESG-ownership – assets and importance are growing

As previously discussed, a growing number of investors engages with companies to influence their behavior on ESG issues. As illustrated in Figure 1, the volume of assets managed with an explicit commitment to engage, make proposals or vote on ESG issues grew from 2014 to 2018 by 66%, or 13,5% annually, to 9834 bn USD. This makes active ESG-ownership the third largest sustainable investment strategy. In addition to this, a large fraction, 63%, of institutional investors have engaged in direct discussions with management and used several other channels of engagement, see McCahery et al (2015).

Figure 1: Assets in the Active Ownership strategies (in bn. USD).



Source: GSIA, 2016 and 2018.

Before discussing how investors could benefit from active ESG-ownership it is useful to clarify what is meant by it and how the engagement process works in practice.

Active ownership is an investment strategy where investors are exercising their right to monitor and possibly change the behavior of companies. It can be done by either making proposals, voting[3] or directly engaging with company on management or board level, and in some cases with the nomination committee as well.

There are no global standards for how this should be done but many investors have chosen to follow the six PRI principles, where signatories commit themselves to include ESG information in the investment process (principle 1) as well as into being active owners (principle 2).

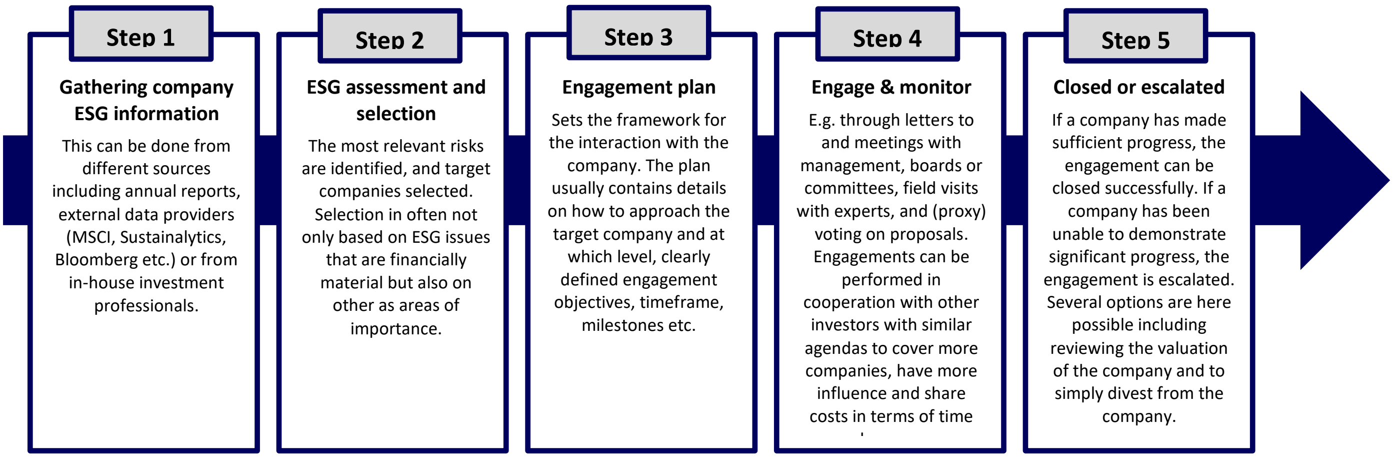
It varies between investors how the engagement process is done in practice but it usually involves the following main steps described in figure 2.

The volume of assets managed by institutional investors on behalf of beneficiaries is important to notice when trying to understand how institutional investors can potentially be impactful through active ownership strategies. Generally, institutional investors own a significant and growing part of the public market. In the US the fraction has increased from 16% in the sixties to around 60% today, see Celik and Isaksson (2013). The size of their holdings and better access to resources are clear advantages for a successful active ownership.

[2] Fundamentals are factors that are expected to influence the perceived value of a stock, e.g. cash flow, & return on assets. If these remain unchanged or decrease less than the price, it will be attractive for value investors to buy the stock.

[3] Proxy voting is when someone is voting on behalf of the rightful stock owner at the annual general meeting.

Figure 2: The five steps in the engagement process.



Active ESG-ownership – Financial and sustainable performances are encouraging

From an investor's perspective the success of active ESG-ownership should ultimately be evaluated on its ability to improve the sustainable and financial performance of the engaged companies.

Available research indicates two important conclusions:

First, engaged companies seem to improve their financial performance and secondly, success rates and ESG-scores seem to suggest that the sustainability has also improved. This suggests active ESG-ownership can have an economic and sustainable impact.

Companies targeted for engagements

While all companies can be target for engagements to handle incidents or improve their standards, companies with a low ESG score, poor financial performance, high liquidity and other institutional owners are more likely to be targeted. This makes sense intuitively because the potential for improvements seems to be higher.

That lower performing companies are targeted as well, is important for investors to notice about active ESG-ownership strategy. It is a strategy where the intention is to actively improve companies with lower ESG performance which means funds will also hold companies with lower ESG scores.

Characteristics of a successful engagement

Successful engagements seem to have in common that the companies prior to engagement had low valuation, low returns, high liquidity, highly advertising as well as some economic of scale to harvest, see Dimson et al (2015). Co-operation between institutional investors as well as previous (successful) experience with engagements also improves the likelihood of a successful engagement.

These findings confirm that active ownership could be a valuable mechanism that could drive low performing companies to have higher value in the long run. Perhaps by changing the focus of the company from short term to a long term strategy. Focusing on undervalued and lower performing companies, when engaging, is also consistent with how active ownership was mainly done historically by some institutional investors and private equity companies in particular. In these cases performance and corporate governance issues were also dominating. It also makes intuitive sense that engagements could be more successful if investors co-operate. They become more powerful in voting and in meetings with management and they have the possibility to share the non-negligible costs for engaging, see Dimson et al (2018). What could be more surprising to notice is the fact that a low ESG score does not appear to be essential for a successful outcome of the engagement; i.e. even companies with a relatively high ESG-score can benefit from engagements. As a final note, among the three different ways shareholders can do activism (voting, engagements and divesting) private engagements are the most preferred type among institutional investors, see e.g. Dyck et al (2019).

Sustainable performance of engaged companies

If active ESG-ownership is to have any positive effect on the sustainable performance of companies in funds and society, the success rates of the ESG motivated engagements need to be relatively high; i.e. where investors have been successful in getting management to acquiesce their demands. This seems to be the case with success rates ranging from 18%-60% depending on the time period and global reach of the underlying studies, see Figure 3. Success rates have generally increased over time which could be caused by an increased interest and awareness for sustainable topics among shareholders and company management globally. These results should not be too surprising to investors as these success rates are in line with historical success rates of active ownership (on other issues than ESG) where institutional investors have also been able to document a high success rate in accomplishing their objectives from active ownership of around 35%, see Gillian and Stark (2000), in particular when they co-operated with other institutional investors.

It is tempting to make further inference on how the success rates are related to the engagement type (i.e. if it was motivated by an E - Environmental, S - Social or G - Governance issue) but no clear pattern appears. However, G is usually considered the cheapest to improve for companies which can explain why G often have a high success rate. E, on the other hand, is usually considered expensive to improve but investors are engaging on E despite this.

Successful engagements on E require time and long term owners to improve and this will eventually be reflected in an improved ESG-score, (18%), see Barko et al (2018). This is important for investor to notice because it indicates that when environmental engagements are successful, the impact could be significant.

Another way to measure any potential improvements in sustainability after engagements could be to evaluate if engaged companies improved their ESG scores. Unfortunately, there is only very little, but consistent research available within this area. This points to that companies with a below mean ESG-score seem to benefit the most from successful engagement. Their scores improve in the range of 13,7%, see Barko et al (2018). The G-score also seems to improve from engagements. Moreover, investors should notice that institutional investors domiciled in countries with high social norms and is a United Nations Principles for Responsible Investment signatory have a larger positive impact on ESG-scores, see Dyck et all (2019). Private and socially concerned investors could use this information to select the institutional investor.

It is important to emphasize that the sustainability of companies could have improved even if the financial performance has not improved. Whether the financial performance is positively affected by the engagements is related to whether the market believes the value of the companies have improved and therefore would reward this. Sustainable improvements could happen without the value of companies increasing.

Figure 3: The success rates of ESG motivated engagements

AUTHORS	NR OF ENGAGEMENTS	DATA PERIOD	REACH	SUCCESS RATES			ENGAGEMENT TYPE		
				TOTAL	ES	G	E	S	G
Dimson et al (2015)	2 482	1999-2009	US	18 %	13 %	24 %	25 %	25 %	50 %
Barko et al (2018)	847	2005-2014	Global	60 %	56 %	78 %	42 %	43 %	14 %
Hoepner et al (2019)	1 712	2005-2018	Global	31 %	-	-	22 %	20 %	43 %
Dyck et al (2019)	147	2004-2013	Global	33 %	-	-	-	-	-
Dimson et al (2018)	1 671	2005-2015	Global	42 %	-	-	-	-	-

Financial performance of engaged companies

The financial performance of engaged companies is illustrated in Figure 4[4].

The sample of all engaged firms experienced on average positive excess returns after the engagement, and the excess return of successful engagements is even slightly higher.

In two of the three studies the accounting return also improved, and in the studies that measure equity risk there is evidence of a decrease in risk following the engagement, see Dimson et al (2018). Critics could argue that this is merely showing short term improvements but the fact that the excess return has not dissipated within the first twelve month and the accounting measures have improved as well suggests that the active ownership has indeed improved the *long term* performance and profitability of the company.

It is important for investors to notice, that when all engaged companies on average have a positive excess return it does *not* mean that all engaged companies (successful and unsuccessful) will have a zero or positive excess return. On the contrary, it could be the case that unsuccessful engagements will result in a (slightly) *negative excess return* as the market will see this as a signal for a hostile or incapable management that is damping the long term profit opportunities. This type of principal-agent problem is confirmed by empirical research where managers may not always act in the interests of the shareholders owning the company (or other stakeholders). The market rewards positive news from a company with a poor history of stakeholder relations and reacts negative to news that appears to reflect agency problems, see Krüger (2014).

Private Equity and Hegde Funds should not be forgotten by sustainable investors

Institutional investors are not the only type of investors who have practiced active ownership historically. Private equity and hedge funds have for years engaged actively with companies. It is therefore relevant for investors to understand if investors should also consider private equity and hedge funds as investment vehicles to improve the long term financial and sustainable performance of companies.

The key difference between traditional institutional investors and, on the other hand, private equity and hedge funds lies in different motives behind the active ownership. Private equity and hedge funds acquire a (large) stake in carefully selected companies with the intention to bring about changes and realize a profit from it. Traditional institutional investors do not acquire holdings in a company with the specific purpose of changing the company behavior unless there is a need for it.

Other differences include private equity and hedge funds being less diversified, management have clear financial incentives, are under less regulation and fiduciary responsibilities, are under less public and political scrutiny as well as have the option to pursue both a non-confrontational and a confrontational approach in the engagements or proxy fights. These characteristics position both private equity and hedge funds well for executing impactful active ESG-ownership which is confirmed in high success rates.

Figure 4: Financial performance of ESG-motivated engagements[5]

AUTHORS	NUMBER OF ENGAGEMENTS	DATA PERIOD	REACH	EXCESS EQUITY RETURN AND RISK			
				ALL ENGAGED	SUCCESFUL	RISK REDUCTION	IMPROVED ACCOUNTING RETURN
Dimson et al (2015)	2 482	1999-2009	US	+2.3%	+7.1%	-	YES
Barko et al (2018)	847	2005-2014	Global	+1.9%	+2.4%	YES	NO
Dimson et al (2018)	1 671	2005-2015	Global	+3.5%	+4.1%	-	YES
Hoepner et al (2019	1 712	2005-2018	Global	-	-	YES	

[4] Returns are annualized and measure the excess return in the 12 months after the completion of the engagement; either as Carhart(1997) adjusted or market-adjusted excess return. Risk reduction is either measured as volatility or downside risk measures, and accounting return is measured as return on assets or return on investment.
[5] Past performance is no guarantee of future return. Investments imply risk.

Although private equity and hedge funds differ in their objectives with the active ownership[6] both types have been able to document a high success rate in accomplishing their objectives from active ownership, 60%-65%, and getting management to acquiesce to their demands, see Klein and Zur (2007). Moreover, substantial abnormal returns have been achieved from these types of active ownership which has not dissipated in the following years; see Brav et al (2008).

This suggests that private equity and hedge funds can be effective in changing company behavior through active ownership, which would also include changes related to ESG issues if these were the objectives. Moreover, the market (on average) believes this type of active ownership creates long term shareholder value. Historically, private equity and hedge funds have had other objectives with their engagement than improving the sustainability of the engaged companies and the society in general. However, investors should pay attention to the growing number that have started to pursue sustainability targets as well. Investors should not forget these as a potential source of improving the long term financial and sustainable performance.

Company management has incentives to comply to investor ESG demands

The discussion so far has mainly focused on investors and their reasons to engage. To complete the discussion one also has to understand the incentives companies may have to engage in active ownership with investors.

First, active ownership may allow management of the company to focus more on the longer term rather than the short term as some investors may prefer. The incentive should be strong as the empirical evidence for higher performance, when focusing on the long term, is clear. Second, companies must always ensure availability of sufficient capital and preferably not at a higher cost of capital than competitors. If a sufficient amount of the capital in the market comes from ESG conscious investors, who require companies to comply with higher ESG standards, then the company could have an incentive to implement higher ESG standards to be able to attract this type of capital, see Landier and Lovo (2020). Investors should notice this because assets in these ESG-strategies have increased significantly in recent years and have become relevant for companies to consider. This also suggests ESG conscious investors should focus their capital in sectors, countries or regions where the size of their sustainable capital can be used to change the behavior of companies. Third, by engaging in discussions with investors, companies are likely to get access to valuable knowledge on ESG topics that can be used to drive up the value of the company; for instance, by subsequently looking for further areas to improve, see PRI (2018b). Forth, the company value is likely to increase in a way that will also benefit management and the ongoing business. This includes greater customer loyalty, higher customer satisfaction as well as a broader investor clientele. The value of being able to advertise on ESG improvements may also benefit management. Finally, regulation is also changing and is likely to change more in favour of sustainability.

However, as discussed earlier, management may also have incentives that are not aligned with shareholders. Management of some companies could engage in costly ESG initiatives in order to promote themselves at the expense of shareholders and the long term profitability, see Bénabou and Tirole (2010).

[6] Broadly speaking, private equity funds are targeting businesses with a potential for improving operational inefficiencies (and therefore earnings) whereas hedge funds are targeting profitable companies but with the aim to reduce excess cash (and increase dividends and payments to creditors), buy back of own share, executives compensation and inefficiencies in general.

What are the most important points for investors to learn?

There are reasons to be optimistic from a sustainable investor point of view as research shows active ESG ownership works. Four aspects deserve to be mentioned

1. **Improved financial performance and sustainability:** Engaged companies seem to improve their financial performance and secondly, ESG-scores (i.e. the sustainability) also seem to improve[7]. Moreover, the improvements do not appear to be only short term gains. This makes these findings of interest for all investors; i.e. not only the ESG conscious investor. It also suggests active ESG-ownership can have an economic and sustainable impact and play a central role in not only creating increased shareholder value but also improving the welfare of the society.

2. **Options for private investors:** Private investors are the beneficiaries and owners behind the institutional investors. Realistically, they cannot engage with companies themselves but what they can do is to select between institutional investors depending on whether they are engaging actively on ESG issues. In pursuing the opportunities within the ESG area, investors should not forget private equity and hedge funds as they could also be highly capable to drive sustainable changes.

3. **Divestment not as efficient for creating impact:** While divestment in theory could be an option to improve sustainability by increasing the cost of launching unsustainable projects, it is less likely to work in practice for institutional investors. Moreover, by divesting an investor can no longer influence the company through e.g. voting and the new investor clientele might be more adverse to ESG improvements.

4. **Continued market rewards from engagements:** In the first issue of the Sustainable Investments Publication ("A Guide to sustainable investing"), it was argued that the use of ESG information in the investment process seems to have provided an above market return in recent years and is likely to continue in the years to come. The evidence of active ESG-ownership points in the same direction. The market seems to reward companies for improvements in sustainability and investors should pay attention to this when formulating their investment policy.

[7] Past performance is no guarantee of future return. Investments imply risk.

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