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**The role of institutional investors as activists: a critical review of Active Ownership**

Nova SBE Consulting Project

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# The role of institutional investors as activists: a critical review of Active Ownership

## Abstract

The following study serves as a conceptual compendium of relevant information about active ownership for *BPI Gestão de Activos*, a Portuguese asset management company. Initially, the author develops the topic by drawing on prior empirical evidence on the financial benefits of active ownership. At the next stage, guidelines on how to build an effective active ownership policy are provided, with a focus on the due diligence process, prioritization and methods of engagement of both voting and engagement activities and respective transparency. Specific considerations are given for activists investing in fixed income securities, emerging markets and engaging with public policymakers. Finally, the author uses a Brazilian power generation company - Eneva - to guide a practical approach on implementing active ownership.

**Keywords:** Institutional investors, Activism, Engagement, Proxy Voting

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## Introduction

The 2008 crisis indicated the beginning of the “post-industrial type of capitalism driven by financial markets and focused on the search for profitability” (Davis, 2009<sup>1</sup>). Relevant dominant forces in this landscape are institutional investors, such as pension funds, that amount to a considerable proportion of assets. The proportion of publicly held companies institutional investors incremented from 19% to 60%, between 1970 and 2006 (Bd. of Governors of the Fed. Reserve System, Flow of Funds Accounts of the United States<sup>2</sup>). The superpower of institutional investors allows them to impact corporate culture, using multiple governance mechanisms, such as voting activities, Annual General Meetings (AGM) or engagements with management teams.

While the early view on activism was proclaimed to be of a “waste of management’s time and the corporation’s money” (Cane, 1985<sup>3</sup>) by Fortune 500 companies, scholars now defend shareholder activism as a new social movement which has shifted the balance in enterprises’ stakeholders, namely between CEOs, boards and shareholders, in favor of shareholders (Kahan et al., 2010<sup>4</sup>). This new phenomenon symbolizes the intent of having companies’ management be more accountable for their actions and more focused on shareholder interests. (Bebchuk et al., 2005<sup>5</sup>).

The concept of active ownership comprises “actions taken by shareholders with the explicit intention of influencing corporations’ policies and practices” (Goranova et al., 2014<sup>6</sup>), but also expands to a broader variety of behavior, namely to the development of mutual exchanges with corporations aimed at grasping a long-term stance toward investment (McNulty et al., 2016<sup>7</sup>). Shareholder activism may target corporate governance and performance, and more recently, environmental, social and governance issues (Clark et al., 2012<sup>8</sup>).

According to the United Nations-supported Principles for Responsible Investing (UNPRI), active ownership is considered “the use of rights and position of ownership to influence the activities or behavior of investee companies.” It may be used in different manners depending on asset classes. Concerning equities, it encompasses both engagement and voting. Engagements capture “any interactions between the investor and current or potential investee companies on Environmental, Social and Governance (ESG) issues and relevant strategies, intending to improve ESG practices and/or ESG disclosures.” It comprises a “structured process that includes dialogue and monitoring companies.” Voting is defined as “the exercise of voting rights on management and/or shareholder resolutions to formally express approval or disapproval on relevant matters.”. Voting may be exercised in person and proxy, in which a decision-making group can direct his/her voting power to another entity (UN PRI, 2018<sup>9</sup>).

Active ownership is also universally regarded as an effective method to cut risks, boost returns and have a beneficial influence on society (Danske Bank Asset Management, 2019<sup>10</sup>). Alternatively, merely divesting means that investors have no ability to push for responsible corporate practices and this alternative is presently frowned upon (UN PRI, 2018<sup>9</sup>).

This practice does not have to be restricted to discussions about ESG issues. In actuality, its scope can be broadened and entail discussions on “overall business strategy, capital allocation, the future direction of a company and suitability of investor communications” (UNPRI, 2018<sup>9</sup>).

## Related Literature

In this section, a critical overview of the link between active ownership initiatives and returns and risk metrics is provided by mentioning previous academic work.

Dimson et al. (2012)<sup>11</sup> concluded that engagements led to a one-year positive average alpha of 2.3%, after the first engagement. When the topics of climate change and corporate governance are addressed, abnormal returns tend to be more pronounced. It should also be noted that collaborations between the asset manager and socially conscious institutional investors significantly increases the success rate of engagements, especially if the combination of shareholdings represents a considerable amount of total ownership. Moreover, the authors also found evidence that cooperation with hard collaborators (e.g. Socially Responsible Investing (SRI) funds, pension funds), compared with soft collaborators (e.g. non-profit organizations, media) leads to a higher success rate, considering the former as activist investors and the latter, passive principals. Finally, success was found to be more probable if the company is subject to high reputational risk.

Junkin et al. (2015)<sup>12</sup> found that the firms targeted by the California Public Employees' Retirement System's (CalPERS) engagement activities, from 1987-2008, outdid the Russell 1000 index, on average, by 14.4%. Moreover, while for the three years before engagement, the engaged companies returned a total of 36.1% below comparable groups, in the five years after activism, the same firms showed an excess return of 11.2%, compared to the same group.

Becht et al. (2010)<sup>13</sup> determined that the Hermes U.K Focus Fund (HUKFF), characterized by its high-intensity activism efforts, substantially outperformed the benchmark, FTSE All-Share index, over the period 1998-2004, by exhibiting an annualized abnormal return of 4.9%. The research also estimates that 90% of such abnormal returns come from activist outcomes.

Hoepner et al. (2016)<sup>14</sup> tracks the success of an investor's ESG-related interventions, by reflecting on four milestones: (1) whether the investor raises a concern with a target company; (2) whether the firm recognizes the concern was introduced; (3) whether the company takes action to address the issue; (4) whether the investor successfully concludes the engagement. In what regards to the connection between downside risk and engagement activities, no clear risk reduction comes as the result of the engagement while considering every intervention. In contrast, a considerable risk-reduction effect of ESG engagements, on targets in which Milestone 2 was achieved, was observed. The imposition of a stricter restriction – Milestone 3 being achieved – lead to an enlargement of the magnitude of the effect by a factor of five. Finally, by filtering for solely successful engagements, the risk-reduction outcome decreases annualized standard deviation by 38%, compared to the pre-engagement period.

Nevertheless, while analyzing the information from previous scholar work, two active ownership-related issues seem to be somewhat overlooked for the lack of evidence about them: the considerations on how to implement active ownership in different asset classes, namely fixed income securities, and in emerging markets, given that preceding studies use data from advanced markets. The subsequent sections intend to fill in the gap in the literature on how these practices can be applied accounting for these different scenarios.

## **Developing and Active Ownership Policy**

Given specific investment strategy (e.g. asset classes, types of funds, time horizon and focus industries) conceived by an asset manager, the next phase on integrating active ownership in decision-making goes through defining the organization's active ownership approach directly in the investment policy. This is considered best practice given that it signals to stakeholders that active ownership is an essential component in executing investment objectives.

This policy should be periodically reviewed to account for previous engagement and voting experiences, new beneficiaries' outlooks, and latest ESG advancements. Investors can build policies internally, but using feedback from beneficiaries is advisable, especially concerning sustainability-related issues. Under a scenario of assets being internally managed and in-house development of active ownership initiatives, the progress of the various departments in implementing the policy should be supervised by the investment committee.

An integrated active ownership policy should specify the following areas:

### ***Engagement***

- ESG issues: summary of the primary topics the investor wants to get exposure to (i.e. climate change), and international initiatives target firms are expected to abide by;
- Due diligence: an outline on how to supervise ESG developments of portfolio companies to identify potential engagement targets;
- Prioritization of engagements: presentation of the criteria to prioritize engagements (e.g. largest holdings, specific markets, controversies, client requests) and describe whether the organization's engagement activities are primarily reactive (i.e. seeking

dialogue in reaction to controversy or scandal) or proactive (i.e. pursuing engagement on a preventive basis);

- Methods of engagement: report on how to communicate with enterprises (e.g. letters) and guidelines on collaborative engagement;
- Escalation strategies: explanation of how the organization responds to unsuccessful engagements (e.g. communicating with the board, issuing a public statement, reducing exposure);
- Transparency: disclosing to beneficiaries and the public the progress on ongoing engagement activities at a reasonable frequency (e.g. annually).

## ***Voting***

- ESG issues: summary of ESG factors that are accounted for when making voting decisions (e.g. executive compensation);
- Decision-making processes: procedures to influence voting activities, englobing the role of proxy voting advisors;
- Prioritization of voting activities: discussion on the scenarios in which voting activities are conducted (i.e. if holdings are above a certain threshold);
- Methods: explanation on how the organization votes (e.g. in person, proxy)
- Company dialogue: how to prioritize communication with companies prior to and after voting;
- Transparency: whether the organization keeps track of votes cast and discloses important outcomes to clients.

## Considerations on engagement in fixed income

Although bondholders do not own shares of the company and do not hold voting rights, engagement is still a possibility for fixed income investors in incorporating active ownership in their investment analysis.

Generally speaking, ESG factors can impact bond valuation at different levels, namely: issuer-specific risk (e.g. regulatory compliance, brand reputation), sector risk (e.g. regulatory and technological changes) and systemic risk (e.g. stranded asset risk in oil refiners and pipeline providers). ESG factors provide a more comprehensive view of a bond's value by modifying the perception of risks associated with a bond and can help differentiate bonds with similar financial profiles.

From an asset manager standpoint, corporate transparency and third-party ESG research can be deficient for fixed income investors in comparison to listed equity investors as “bond investors report unsatisfactory communication from issuers, who are seen to disproportionately cater to equity investors, despite bond investors' growing importance as a source of financing for companies” (DVFA, 2012<sup>15</sup>). Moreover, data availability may not translate to usefulness to bond valuation. The asymmetric return profile of investing in fixed income compared to listed equities emphasizes the relevance of accurately identifying ESG factors that can affect downside risks and long-term credit quality. For instance, “executive pay and board diversity are most likely not sufficiently material to an issuer's credit strength to feature in an investor's credit research” (UNPRI, 2018<sup>16</sup>).

Ultimately, a holistic view of effective bondholder engagement should follow a suitable structure. Firstly, research should be conducted on identifying cases of potential engagement, accounting for both the materiality of ESG issues and the likelihood of success in influencing the issuer's management of ESG risks and opportunities. Secondly, the asset manager needs to

prioritize engagements with issuers based on specific criteria (e.g. exposure, materiality). Thirdly, the engagement should be initiated, either individually or via collaboration, and discussions around ESG topics should take place and seek feedback to improve subsequent engagements. Finally, the activist should set targets for the outcomes of engagement activities and monitor the progress of the target company against his/her expectations.

## **Active ownership in emerging markets**

Emerging and frontier markets display exciting opportunities for long-term investors, but the markets operating in these markets stand facing a variety of environmental, social and governance matters (Odell et al., 2016<sup>17</sup>).

The dominant pattern in emerging markets is of concentrated ownership, with most shares owned by founders and family members (La Porta et al., 1998<sup>18</sup>). Collectively, these could control firms' important events (e.g. election of the members board of directors), while some institutional investors represent a large volume of public float. Internally, even operationally competitive firms in emerging markets can possess inexperienced investor relations teams and sub-standard disclosure systems. As a consequence, sell-side analysis is restricted and exposure to international investors is virtually missing (Lubrano, 2014<sup>19</sup>).

From an activist standpoint, condensed ownership, in companies that have not done a particularly good job expressing themselves, leads to interaction with the final decision-makers. Moreover, active owners can have a more significant marginal effect in influencing governance and disclosure practices to increment valuation.

The success of engagements, in the emerging markets landscape, depends on how the activist decides to conduct the initiative. As referred earlier, given the concentrated ownership feature of companies, one can seldom threaten any proxy battle to vote out the current management team or board of directors. This fact is even more accentuated when considering the problematic access to law in some of these countries (Poulin, 2004<sup>20</sup>). The activist investor needs to rely foremost on the team, guiding the engagement ability to influence companies' officials that the suggestions the activist is promoting lead to superior performance. The persuasion process usually requires convincing evidence to have success. A reasoned analysis of the opportunities to increase value and the respective upside projections are results of the

activist's intense due diligence process, which can be embraced by the company as complimentary consulting advice (Lubrano, 2014<sup>19</sup>).

In cases of unsuccessful engagements, an abrupt exit by an activist could hold a signaling value of a target company's downfall. The possibility of divestment alone can dissuade management from committing mistakes and undergo the necessary changes to keep the activist "on board."

## **Investor engagement in public policy**

Discussions with policymakers on current or future legislation and regulation concerning ESG issues can also be another component of investors' active ownership activities. The outcomes gathered by activists during their exchanges with firms can improve the standards set out by governments and aid in shaping a facilitating environment for sustainable business practices.

Despite the potential benefit of engaging with policymakers, activists are yet to engage intensively with these entities. Reasons put forth to explain this include: “the skepticism about whether public entities are receptive to this kind of interaction, a lack of understanding regarding how to influence policy processes and concern about the costs and timeframes involved in such engagements (UNPRI et al., 2014<sup>21</sup>).”

The wide-ranging spectrum of tools policymakers have at their disposal can align investment with long-term sustainable development and these comprise exclusions (policy could prohibit investments in specific companies), incentives (policy could favor investments in particular sectors), responsibilities (policy could have investors incorporating ESG factors within the delivery of their fiduciary duties), stewardship (could encourage investors to have a leader-like role in the governance of companies in which they are invested) and reporting (policy could require investors to report on ESG risks and performance of assets under management and companies to report ESG implications of their activities).

The Grenelle II case-study illustrates such efforts regarding corporate reporting on ESG issues. At the time of the case, French regulations required public companies to include sustainability-related information in annual reports. However, the information was not required to be audited. In 2009, the French government performed vast research on how the shortcomings could be mitigated. This process included the French investment community,

represented by the French Sustainable Investment Forum (FIR), which had a paramount role in supporting Article 225 of the Grenelle II legislation. This article required firms to report on commitments to sustainable development and to have this information verified by an independent third-party organization. According to the KPMG's 2013 Survey of Corporate Responsibility Reporting (2013<sup>22</sup>), 99% of large French companies reported on ESG issues (94%, in 2011, and 59%, in 2008) and 76% (60%, in 2011) had this information assured.

## **Eneva – a practical case of Engagement**

While it may be tempting to address active ownership in a universal and common way for all target companies, one should identify the ESG factors to materially impact the financial condition in firms within a sector. This section aims to illustrate how an investor should act while identifying ESG issues that are relevant to company performance and to steer interactions with target companies' decision-makers.

For the upcoming discussion, the author highlights Eneva, a Brazilian vertically integrated firm operating in the power generation and natural gas upstream businesses (commonly referred to as Exploration and Production, E&P). The firm also holds a coal thermal generation segment.

From this point forward, the Sustainability Accounting Standards Board (SASB) materiality map, which identifies the critical sustainability issues that are likely to affect firms' performance within an industry, was used to come up with a set of questions that should be raised to the firm's management team or board of directors. In this case, from an environmental standpoint, the most material issues for a firm such as Eneva englobe greenhouse gas emissions (GHG), air quality and water management. In terms of social issues, community relations, workforce health and safety and cybersecurity are appointed as the key topics of discussion. Concerning the governance and leadership factors, business ethics, management of the legal and regulatory environment and critical incident risk management should be addressed.

After extensive research on the firm and given its inherent features, namely its business model, overall strategy and the underlying market in which it operates, and based on the SASB Engagement Guide for Asset Owners and Asset Managers (2019<sup>23</sup>), the author proposes the following ESG-related questions to be asked to Eneva's management team.

## ***Environment***

- What is Eneva's exposure to emissions-limiting regulations?
- What is the company's strategy to manage Scope 1 (direct) emissions?
- How has the firm performed in managing emissions of industry-specific pollutants (NO<sub>x</sub>, SO<sub>x</sub>, VOCs and PM10)?
- How is the firm increasing water efficiency and managing water use?
- How is the company addressing water supply disruptions, particularly in water-stressed regions?

## ***Social***

- What is the firm's process for managing risks and opportunities linked with its relations with the community in which it operates?
- What are the socioenvironmental projects being conducted by Eneva that can bring economic, social and environmental benefits to local communities?
- How has the company performed in addressing employee health and safety?
- How does the firm promote a strong safety culture, including emergency procedures?
- Does the firm possess a cybersecurity policy, and what does it include?

## ***Governance***

- What strategies is the firm adopting for preventing corruption and bribery incidents?
- How does the company engage in the legal and regulatory process regarding policy proposals that address environmental and social factors affecting the sector?
- How does the firm identify and manage catastrophic and tail-end risks?

## **Conclusion**

As a result of the previous scholar work, which gives direction on how active ownership can improve financial metrics, asset management firms should internally design the necessary processes for activism implementation and formalized them in the form of policies, namely on engagement and voting activities. Relevant issues to factor in these guidelines include the prioritization and methods of activism activities, escalation strategies and transparency to clients/beneficiaries and the public. Fixed-income investors should tread carefully when accounting for ESG issues in credit quality, given the immateriality of some ESG factors in credit risk evaluation and possible misuse of current third-party equity-oriented data to inform investment decisions. The concentrated ownership pattern observed in companies operating in emerging markets represents an opportunity for deep collaboration with decision-makers and other institutional investors. Engagement with policymakers can also be performed to help smooth out the transition towards a more enabling regulatory and legal context for sustainable business practices.

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