Principles for Responsible Investment

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

# STEWARDSHIP

AN INTRODUCTION TO
RESPONSIBLE INVESTMENT

EXPLORE THE SERIES

## OVERVIEW

- This guide introduces the topic of stewardship, also known as active ownership.
- It explains the importance and relevance of stewardship within responsible investment and outlines the stewardship tools investors can incorporate into policies, processes and practices.
- It guides investors on how to implement the PRI's Principle 2, which sets out signatories' commitment to stewardship, stating: *"We will be active owners and incorporate ESG issues into our ownership policies and practices".*

The PRI defines stewardship as *"the use of influence by institutional investors to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend."* [1]

Stewardship and ESG incorporation (which sees investors include ESG factors in their investment and capital allocation decisions) are complementary strategies. Responsible investment involves both, including each feeding back into the other, for example by using insights garnered from engagement[2] to enhance investment decision making – and vice versa.[3]

1 About stewardship (PRI)
2 Provided the information garnered is not material non-public information. Usual practice would be for engagement meetings to avoid discussion of any such information.
3 Technical definitions as used in PRI Reporting are available here.

| CONSIDERING ESG ISSUES WHEN BUILDING A PORTFOLIO (known as: ESG incorporation) | | | INTERACTING WITH ISSUERS ON ESG ISSUES (known as: active ownership or stewardship) | |
|---|---|---|---|---|
| ESG issues can be incorporated into existing portfolio construction practices using a combination of three approaches: integration, screening and thematic. | | | Investors can exert influence through tools including: engagement and voting – two of the most widely used tools – resolutions/ proposals, board roles, supplier monitoring/negotiation, contributing to research and public discourse, litigation. | |
| **Integration** | **Screening** | **Thematic** | **Engagement** | **Voting** |
| Explicitly and systematically including ESG issues in investment analysis and decisions, to better manage risks and improve returns. | Applying filters to lists of potential investments to rule companies in or out of contention for investment, based on an investor's preferences, values or ethics. | Seeking to combine attractive risk-return profiles with an intention to contribute to a specific environmental or social outcome. Includes impact investing. | Interactions between an investor and current or potential investees/issuers, in order to: improve practice on an ESG issue, change a sustainability outcome in the real world or improve public disclosure. Engagement can also be with non-issuers, such as policy makers or standard setters. | Exercising voting rights on management/ shareholder resolutions (and submitting resolutions), to formally express approval (or disapproval) on relevant matters. |

**PRI resources:**

**What is responsible investment?**

**This introductory guide follows three parts:**

| PART 1 | PART 2 | PART 3 |
|---|---|---|
| WHAT IS STEWARDSHIP? | WHY STEWARDSHIP? | HOW TO CONDUCT STEWARDSHIP |

# PART 1: WHAT IS STEWARDSHIP?

Stewardship is investors using their influence over current or potential investees/issuers, policy makers, service providers and other stakeholders – often collaboratively – to maximise overall long-term value. This includes the value of the common economic, social and environmental assets[4] on which returns and clients' and beneficiaries' interests depend.

### EXAMPLES OF WAYS TO INFLUENCE INVESTEES AND ISSUERS:

- Engaging with current or potential investees/issuers, across all asset classes
- Voting at shareholder meetings
- Filing shareholder resolutions/proposals
- Fulfilling direct roles on investee boards and board committees
- Litigating

### EXAMPLES OF WAYS TO INFLUENCE OTHER STAKEHOLDERS:

- Engaging with policy makers and standard setters
- Contributing to public goods (such as research)
- Engaging in public discourse and disclosures that support stewardship goals
- Negotiating with, and monitoring others in the investment chain (e.g. asset owners engaging with investment managers)

## ENGAGEMENT

While stewardship and engagement are often referred to interchangeably, engagement is just one of many stewardship tools available to investors. It primarily refers to an investor (or an engagement service provider) communicating with current or potential investees/issuers (such as companies), to improve ESG practices, sustainability outcomes or public disclosure. (Engagement can also be carried out with non-issuer stakeholders, such as policy makers or standard setters.)

Engagement typically takes the form of meetings, calls, emails or letters between the investor and the engagement target during which issues are discussed and investors make clear their expectations. Good engagement identifies relevant ESG issues, sets objectives, tracks results, maps escalation strategies and incorporates findings into investment decision making.

Engagements (with investees or other stakeholders) can be carried out individually, collaboratively with other investors or via a service provider.

**Individual engagement** sees an investor engaging on their own with current or potential investees/issuers.

**Collaborative engagement** sees a group of investors engaging investees or issues together. This could be done as part of a formal investor network or other membership organisation, but not always. Investors in the group may play differing roles in the engagement. Collaborative engagements allow investors to: enhance their leverage and legitimacy, pursue collective goals (such as addressing the free-rider problem[5]), share information with each other and other stakeholders and spread the cost and effort.

**Service provider engagement** sees investors appointing commercial service providers to engage investees/issuers, or investor organisations engaging investees/issuers on their members' behalf. Such service providers have an explicit mandate to represent their members' interests when engaging.

4 About stewardship (PRI)

5 The free-rider problem includes where some avoid the costs of addressing collective problems, while reaping the benefits.

**PRI resources:**

- Getting started with collaborative engagement
- Acting in concert research
- Current PRI-coordinated collaborative engagements
- PRI Collaboration Platform

### INVESTOR-INVESTEE/ISSUER INTERACTIONS THAT ARE NOT CONSIDERED ENGAGEMENT

Interactions that are not seeking changes in practice or disclosure are not engagement. This includes:

- interactions with companies for data collection and/or for research purposes related to buy/sell/hold investment decisions;
- standard questionnaires sent to companies to gather information and make investment decisions;
- attendance at a company presentation, AGM or other company meeting without interactions or discussion;
- bulk disclosure requests for ESG information (typically conducted via a third party).

## ESCALATION

If engagement with an investee or issuer is unsuccessful, investors may consider filing shareholder resolutions, using voting power to replace unresponsive directors, pursuing litigation and speaking out publicly (such as an op-ed in the media).

## VOTING

Voting is an essential tool for listed equity investors to communicate their views to a company and input into key decisions, such as director appointments and board pay. Resolutions proposed by shareholders increasingly relate to social and environmental issues as well. Voting involves developing a voting policy, research, casting votes and communicating with investee companies before and after the AGM.

While outsourcing voting activities to proxy advisors is essential for investors that hold thousands of companies, responsible investors dedicate time and resources towards ultimately making their own informed decisions, rather than automatically acting on their advisor’s recommendations.

# PART 2: WHY CONDUCT STEWARDSHIP?

A range of financial, regulatory and sustainability motivations are driving asset owners and investment managers to undertake stewardship.

## IMPROVING RISK-RETURN

There is a growing body of academic and industry evidence that identifying and addressing ESG factors contributes to relative outperformance[6]. The PRI has collated a register of academic research covering a range of topics, including the role of stewardship in improving both corporate financial performance and outcomes in the real world.

**PRI resources:**

- **Academic ESG review**
- **How ESG engagement creates value for investors and companies**

## REGULATION

Pensions, financial regulators and policy makers are increasingly encouraging institutional investors to take an active role in overseeing and influencing investee companies, including through stewardship codes, the first of which was published in the UK in 2010. These codes or standards – some voluntary, some mandatory – outline good practice for investor engagement with companies and are designed to enhance the quality of this engagement. A wide range of countries – including Japan, South Africa and Malaysia – have introduced stewardship codes.

Many codes and regulations such as the UK Stewardship Code and the European Union Shareholder Rights Directive II (2017/828/EU) place explicit requirements on investors with regards to how their stewardship addresses ESG issues. International bodies such as the OECD have also introduced guidance on governance and responsible business through the G20/OECD Principles of Corporate Governance, and the OECD Guidelines for Multinational Enterprises: Responsible Business Conduct for Institutional Investors.

## FIDUCIARY DUTY

Undertaking stewardship is widely considered part of an investor's fiduciary duty to their clients and ultimate beneficiaries. It's important to consider the outcome achieved and the process followed to assess whether these duties have been met. The growing body of academic literature suggests that to not effectively use engagement and other stewardship tools to manage risk and maximise returns, may be misaligned with such duties and obligations to clients and/or beneficiaries.

**PRI resources:**

- **PRI's work on fiduciary duty**
- **Legal Framework for Impact**

## UNIVERSAL OWNERSHIP

Investors with well-diversified, multi-asset, global portfolios are often referred to as universal owners, as their holdings are sufficiently diversified across industries and asset classes that they effectively hold a slice of the overall market. Universal owners are therefore concerned with both individual asset returns (alpha) and overall economic performance (beta)[7], meaning universal owners are incentivised to look beyond the interests of their individual investees to engage on systemic issues, supporting broader sustainability outcomes and well-functioning financial markets.

6 Flammer (2015) Does corporate social responsibility lead to superior financial performance? A regression discontinuity approach
Dyck et al. (2019) Do institutional investors drive corporate social responsibility? International evidence
Hopener et al. (2018) ESG Shareholder Engagement and Downside Risk
Dimson, Karakas, Li (2015) Active Ownership

7 Quigley (2020) Universal Ownership in Practice: A Practical Positive Investment Framework for Asset Owners
Hawley and Lukomnik (2018) The Long and Short of It: Are We Asking the Right Questions? Modern Portfolio Theory and Time Horizons

## FOCUS ON REAL-WORLD OUTCOMES

There is ever more expectation from regulators, clients and beneficiaries for investors to consider the real-world outcomes of their investments. By using their influence, through investee/issuer engagement, voting, policy engagement or any of the other stewardship tools highlighted above, investors help to drive changes that lead to improved real-world outcomes. While divestment can be an important tool, divestment alone weakens an investor's influence over the entity and may do little to improve outcomes in the real world.

The UN's Sustainable Development Goals are increasingly seen as a useful framing for these considerations. The PRI's Investing with SDG Outcomes outlines the connection between a) the financial risks/opportunities arising from ESG issues and b) the positive/negative outcomes in the real world.

**PRI resources:**

**The SDG investment case**

**Investing with SDG Outcomes: a five-part framework**

# PART 3: HOW TO CONDUCT STEWARDSHIP

There are a series of steps that all asset owners and investment managers should undertake, as well as a number of asset class specific considerations.

## POLICY

Develop and disclose a stewardship policy consistent with local regulation, stewardship codes and the six Principles for Responsible Investment. This policy should be aligned with the organisation's investment strategy and reviewed regularly.

The scope of the policy and the assets it covers should be clearly highlighted. Among other things, it should highlight the organisation's stewardship objectives, the stewardship tools the organisation uses, the role of collaboration, how inside information and conflicts of interest are managed and how stewardship activities link to investment decision making.

The stewardship policy can include information regarding voting decisions, but many organisations have a separate voting policy. This latter policy can often include specific guidelines or principles that determine how organisations vote on certain issues, the decision-making process on voting and the organisation's approach to filing or co-filing resolutions.

**PRI resources:**

**Database of investors' responsible investment policies**

## PRACTICE

Important aspects of stewardship practice include prioritising which ESG issues – and which investees or other targets (such as policy makers) – to focus on, how stewardship objectives are set and monitored and the approach to escalation.

Differing ownership structures means stewardship practices often differ between asset classes. Whilst most commonly associated with listed equity, stewardship can be practised across many asset classes.

### LISTED EQUITY

Listed equity investors can use their position as shareholders of companies to influence what activities those companies engage in and how they behave and operate. This can happen by engaging with companies (which may be done individually or collaboratively), through the CEO, CFO or IR functions, or through industry bodies.

Listed equity investors can – and increasingly are expected to – exercise their legal (e.g. voting) rights to communicate their views to a company and input into key decisions, such as director appointments and board pay – both by voting on management/shareholder resolutions and by filing resolutions themselves (in jurisdictions where this is possible).

**Passive strategies**

With the growth of assets invested in passive strategies, how passive investors use their voting rights and engage with investee companies has become increasingly important. The different approaches and challenges are explored in the PRI discussion paper How can a passive investor be a responsible investor? The subsequent signatory consultation results find that leading passive investment managers, as universal owners, must look to reduce the barriers to collaborative engagement and focus on the most pressing and systemic ESG issues.

**PRI resources:**

**A practical guide to active ownership in listed equity**

**Snapshot of PRI data on responsible investment in listed equity (2017 – 2020)**

## FIXED INCOME

While not in the same position as shareholders, fixed income investors are still important stakeholders with influence over issuers and clearly defined legal rights. Fixed income investors can therefore interact with issuers to address how they behave and operate.

For corporate fixed income investors, contact with the issuer is often with the company CFO or treasurer. For sovereign debt investors, the engagement process might involve meeting not only government officials, but also trade unions, employers' associations, media representatives and supranational entities such as the IMF, the World Bank or the OECD.

Key points of engagement for corporate and sovereign fixed income investors may be around debt origination and reissuance. Escalation strategies may involve choosing to avoid new debt issues, underweighting or divesting.

**PRI resources:**

- **ESG engagement for fixed income investors**
- **A practical guide to ESG engagement in sovereign debt investors**

## PRIVATE MARKETS

Private markets investors, in particular those with direct exposure to private equity or real assets, are in a unique position when it comes to stewardship, as they often have controlling interests of their portfolio companies or investments, and positions on portfolio company boards.

These investors can use this direct form of influence to meet their stewardship obligations, for example by mandating the adoption of appropriate social safeguards and leading practices (such as adopting the UN Guiding Principles or committing to the living wage). Private equity investors might help portfolio companies improve their environmental management systems and processes, or real estate investors could seek best practice in building efficiency and safety standards.

**PRI resources:**

- **An introduction to responsible investment: private equity**
- **Integrating ESG in private equity – a guide for general partners: ownership**
- **Primer on responsible investment in infrastructure**
- **An introduction to responsible investment: real estate**
- **An introduction to responsible investment: forestry**

### THIRD-PARTY MANAGERS AND SERVICE PROVIDERS

For asset owners, and others with externally managed assets, while stewardship activities such as voting and engagement are often carried out by third-party managers, the asset owner (or other client) still has an important role to play in incorporating stewardship considerations into the selection, appointment and monitoring of such managers.

Investors can also add to their stewardship practice by appointing external providers such as engagement service providers or proxy voting agencies to act on their behalf, particularly for listed equity holdings. Service providers and third-party associations can also be used to engage with policy makers and regulators on key issues that affect the whole portfolio, such as climate change.

**PRI resources:**

**Asset owner resources**

**ESG monitoring, reporting and dialogue in private equity**

**A limited partner's guide to responsible investment in private equity**

## CONNECTING ENGAGEMENT, VOTING AND INVESTMENT DECISIONS

Engagement, voting and investment decisions feed into each other. Research that is carried out for engagement can also be used to determine voting decisions. Alongside voting, investors can file shareholder resolutions to escalate an issue if engagement is unsuccessful. As a last resort, an investor may choose to divest or take legal action against the company or its board.

## ACTIVE OWNERSHIP 2.0

Since the PRI was founded in 2006, the number of stewardship codes around the world has grown, investors have increased the resources they allocate to stewardship activities and external stewardship service providers have proliferated.

But the ambition and assertiveness of many investors means the focus of stewardship practices is evolving. The PRI is working with investors on this evolution through its Active Ownership 2.0 programme – developing an aspirational standard for improved stewardship. It builds on existing practice and expertise but prioritises systemic goals and collective effort aimed at concrete outcomes.

The three central elements to an Active Ownership 2.0 approach are:

- **Outcomes, not inputs or processes:** focusing on the outcomes seen in the real world, rather than being limited to assessing which processes investees/issuers have in place.
- **Common goals:** focusing on outcomes that benefit economies and societies as a whole, rather than on the relative performance of one investee/issuer over another.
- **Collaborative action:** collaborating with other investors and service providers to address these collective goals and deliver real-world outcomes.

Examples of stewardship practice aligned to Active Ownership 2.0 can be found on the PRI website.

**PRI resources:**

**Active Ownership 2.0**

## FURTHER READING

For a list of resources on stewardship from other organisations, visit the PRI website.

## CREDITS

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