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ESG engagements: Why do we engage

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This is the first of a series about engagements and asset managers, a topic not often spoken about in South Africa, and yet a key ESG driver. This first piece hopes to dive a bit deeper into why managers engage at all, and three questions managers should themselves ask before starting an engagement, namely:

1. *What is the appropriate depth and detail of the engagement?*
2. *How does one balance resources for engagement?*
3. *How can the impact of the 'ask' materialise?*

The outcome of engagements, and their chance of success, depend on quite a few factors. The fundamental thread behind successful outcomes is at the heart of the rationale for engagement at all: why do asset managers engage investee companies?

This sounds like a very straightforward question.

It is useful to define engagement for purposes of this series. For ease of reference, given the number of South African PRI signatories, we will use the PRI definition of engagement:

"Engagement refers to interactions between the investor and current or potential investees (which may be companies, governments, municipalities, etc.) on ESG issues. Engagements are undertaken to influence (or identify the need to influence) ESG practices and/or improve ESG disclosure."

But the deeper more investment 'philosophical' rationale is worth a pause. Particularly in South Africa, which is a unique 'biome' for engagement given the tightly held market in many stocks, and high concentration amongst key players.

Driving purposeful action: What is the appropriate depth and detail of engagement?

Investors are the owners of the company, albeit only often a very small sliver. But boards exist at the pleasure of shareholders. This is more acute when there are either strongly collaborative shareholders, or large stakes by key shareholders.

Having appointed boards, who in turn appoint management, the shareholder focus should be on the board. For a useful analogy it would seem remiss to charter a sailing boat, ignore the expert captain of that boat and sailing region, and insist on dealing with the helmsman or navigator, or giving advice on how to trim the sails.

In the same fashion, it is not for shareholders to micromanage the entities into which they invest, but to collaboratively work with their investee companies whilst ensuring their engagement objectives are being met. Practically speaking this can be difficult when it is apparent on the public information at hand that management may be battling to execute the firm's strategy. The danger for shareholders and asset managers is, whilst they may have tremendous experience and knowledge of a sector, they are often not experts in the granular detail of that field of industry or enterprise, for example, on when to deploy capital to very specific industry developments. And at the point in time of stepping in, it is likely more external expertise is required. Bluntly put, management may be on the way out, and this may begin to be reflected in shareholder votes on the broader board itself.

The first question asset managers must ask themselves before any engagement, is where is that line; the duty to engage management on behalf of our clients and get assurances or corrective and decisive action, and when to leave it to those at the helm who have been appointed for the task.

This is the very first balancing act shareholders need to review and reflect upon, not only before they engage, but as an engagement evolves. The answer is not always obvious, though it may appear so with hindsight once the entity is making headlines.

Balancing resources: Is this the right issue to engage upon?

It is always interesting to compare our market to those overseas. In South Africa, one may have to be more proactive in engagement, simply because exiting the stock may not be possible or pragmatic. One may desire exposure to that sector or industry for purposes of investment style, diversification, or opportunity of some secondary exposure. But in a universe as small as the Johannesburg Stock Exchange, finding alternatives might not be easy.

This is however the next question asset managers need to ask – is this worth the bandwidth? For every moment you take the board's time to address this issue, they are losing time on other matters. For large and complex engagements, this is also time lost by the analysts and ESG staff on other matters; they too must balance up their resources.

There are an infinite number of small items asset managers can doubtlessly chase – do they chase lots of small matters to drive incremental industry shifts (and perhaps be seen to tackle lots of companies and be 'active'), or do they tackle few but more meaningful matters.

The second balancing act for asset managers is how to allocate their limited time, as well as that of their investee companies. In some cases, it may be useful to collaborate with other asset managers or engage peers to share perspectives on the same ESG issues—potentially maximising the use of resources and outcomes.

In narrow markets like South Africa, we may end up engaging more than in other markets where, after all other options are exhausted or impractical, it might be more pragmatic to invest in another entity with better ESG credentials.

Focus on outcomes: How can the impact of the 'ask' materialise?

Given the relatively small shareholding overseas, asset managers may have in investee companies, it is unfortunately common for them to meet with less influential staff and be left with limited options to send in written requests. A few months, or quarters later, there may be a concession to draft a position statement or some form of policy around the request.

In South Africa, where a few asset managers can hold very material positions in entities, engagements can happen at board and Chair level. Being careful what we ask for is a watchword; we may well achieve the desired outcome quite quickly.

If we are asking a fossil fuel producer to sell down its assets, or pivot to green energy, or make any similar or fundamental shift, then this will have huge consequences for the balance sheet, cashflows and income. We may be asking for the entity to potentially transition from one form into another.

And with more focused 'asks' come more fundamental outcomes. This is the third complex balancing act for asset managers. The outcomes can impact the entity's valuations, which impact on client returns.

Clients need a particularly clear understanding of what the asset manager stands for, and how this might drive engagements. The onus is both on the asset manager to signal, and the client to understand, these policies and position statements.

Returning to the question: Why do asset managers engage investee companies?

When reviewing the three considerations above (and we will focus on how asset managers engage in the next article), the philosophical answers will impact on all three.

Asset managers feeling pressured to have lots of engagements by clients or consultants may tend focus on quantity

over quality. Engagements will be high in number, and whilst these too can be successful if they are ‘easy wins’, they may skirt more material aspects of sustainability. There is a place for such engagements, where driving the minutiae tends to move the whole. It is just not necessarily reflective of what might be expected of larger asset managers who wish to solve the underlying issues and culture of entities rather than sporadic symptoms.

Asset managers whose motives are to effectively manage the entities they own will tend to have numerous meetings with management, rather than having the board reign in overzealous or too risk averse executives. This is not to say there is not a place for overreaching into the entity, it may be required, certainly this is common in the private equity space, but when it is a dominant theme on public assets, then it should potentially be a reflection point.

Finally, asset managers might have the best of intentions, but they remain guardians of their clients’ assets. ESG incorporation, in most jurisdictions, is a fiduciary duty. It is even written into South Africa’s pension fund regulations. But to the end of serving our clients. Asset managers must not find themselves in tension between their legal and contractual obligations to their clients, being responsible corporate and global citizens, and their own policy agendas. We believe that this is going to become an increasingly complex space.

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