Global Asset Management

The case for engagement

The RBC Global Equity team

When challenged about environmental, social and corporate governance (ESG) aspects of investment choices, investors typically cite the need to engage with companies to effect improvements over time, ostensibly because changes in ESG-related issues cannot happen overnight due to companies' needs to respond both to their business environments and stakeholder expectations.

Critics of a more gradual, collaborative approach argue that it is impossible to 'engage' our way out of global challenges like climate change and that time spent manoeuvring for influence is essentially wasted. They favour taking a harder line in pushing for change, backed by the threat of divestment. Support for this approach can be vocal, particularly from those frustrated by the perceived lack of meaningful action in tackling increasingly tangible global problems.

To understand the case for engagement, it is important to recognise that it is not a tool for crisis management or deploying 'quick fixes'. Complex, systemic problems rarely have simple solutions, but demand deeper understanding and informed interventions. While engagement should always start with constructive discussion, the process may need to be reinforced through firmer measures, such as through voting, public statements or supporting or filing shareholder proposals. While divestment is sometimes necessary, it could be seen as a de facto admission that no improvement is possible. Worse, on selling out, the new investor buying the shares may have lighter ESG standards, making the gesture counter-productive.

On the other hand, engagement is a highly effective tool when faced with uncertainty. One of the complexities faced by companies and investors relates to the quality of the information available to manage non-financial risks. Not only does engagement open a line of communication to encourage fuller disclosure, it helps the investor understand the story behind the reported numbers.

It is noteworthy that the leading providers of external ESG related analysis regularly differ in their ratings. This may be a reflection of the qualitative aspects and uncertainties inherent in ESG issues. At the reporting level, while frameworks such as the Carbon Disclosure Project have improved the consistency of carbon measurement, there is still no unified approach to overall sustainability reporting. Investors, accustomed to globally applicable financial accounting guidelines, should be wary of looking for a quantitative short cut when interpreting ESG-related data as even the most transparent corporate disclosure requires interpretation and context.

For active investors, variation in information sources can create opportunities to identify alpha, each offering a piece of the overall picture and indicating where information gaps may lie. Bottom-up investment strategies invite investors to engage closely with companies to understand the overall business plan, querying those information gaps and any assumptions used in reporting performance. Over-borrowing from nonfinancial stakeholders like employees or the environment, creates contingent liabilities which will inevitably come to light. These can be more easily identified and addressed in advance through dialogue with the company.

With an active ownership mind-set, investors challenge gaps in information, poor forward planning, or weak risk management practices, all with a view to long-term improvement. This integrated approach to incorporating ESG factors can lead to more successful engagement, helping investors and companies to work together to deliver both financial returns and positive change for society.

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