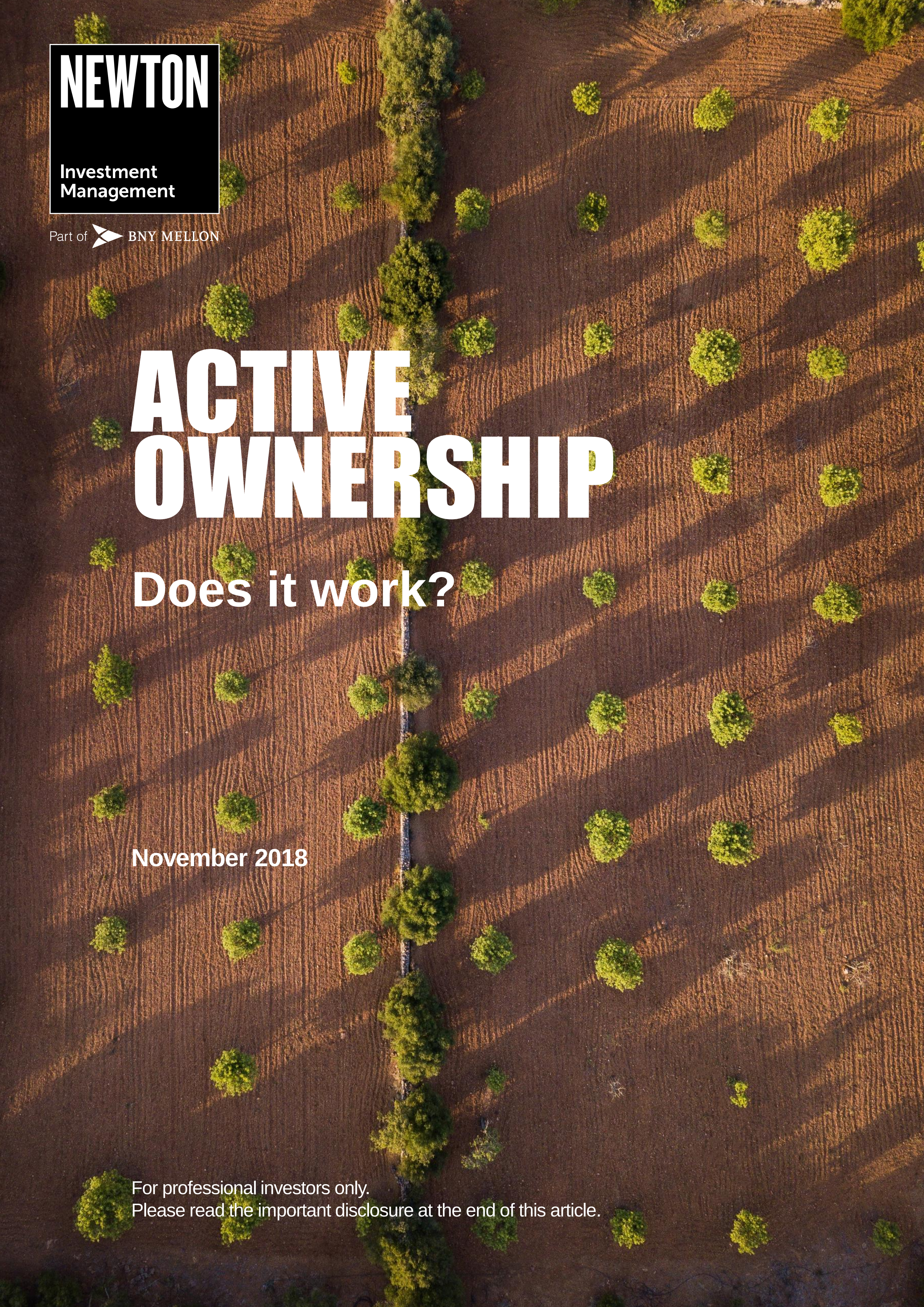

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ACTIVE OWNERSHIP

Does it work?

November 2018

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ACTIVE OWNERSHIP – DOES IT WORK?

As the focus on responsible and sustainable forms of investment increases, debate about the value of engaging actively with companies is intensifying. In this article, we summarise the findings of one particular paper on the topic, which considers whether investors can achieve improved outcomes through such engagement. The paper, entitled *Active Ownership*, is authored by Professor Elroy Dimson and Oğuzhan Karakaş of the University of Cambridge's Centre for Endowment Asset Management (of which Newton has been a long-term supporter) and Dr Xi Li of the London School of Economics. It is with their kind permission that we provide this summary. A full version of the paper is available here.

Responsible investing is becoming increasingly popular. The term is defined by the United Nations-supported Principles for Responsible Investment, the world's leading proponent of responsible investment, as an approach to investing that aims to incorporate ESG factors into investment decisions, to better manage risk and generate sustainable, long-term returns.[1] The 2018 annual Principles for Responsible Investment report lists around 1,900 signatories with almost $90 trillion in assets under management.[2] Meanwhile the Global Sustainable Investment Alliance (2016) estimated that $22.89 trillion of professionally managed assets worldwide incorporate environmental, social, and governance (ESG) concerns into their decisions.[3] A growing proportion of investors are engaging with public companies on ESG issues.[4] Furthermore, there are now 8,346 companies in 161 countries that have committed to responsible and sustainable corporate practices under the 2015 UN Global Compact.[5]

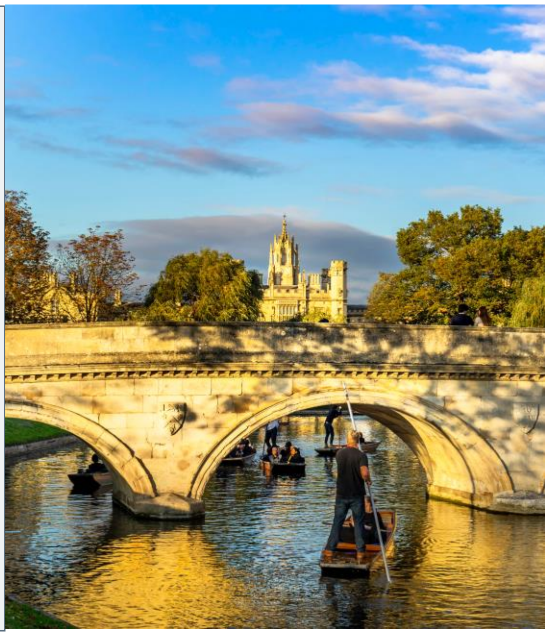
Centre for Endowment Asset Management

Based within the University of Cambridge's Judge Business School, the Centre is dedicated to high quality research that furthers academic knowledge and practitioner understanding of long-horizon investing. The Centre's agenda includes historical perspectives on current investment concerns and research on responsible investment strategies.

The Centre publishes regularly in leading academic journals, hosts conferences, and works in collaboration with a number of other leading institutions. It also performs a key educational role, carrying out teaching in the area of long-horizon investing, and developing case studies of leading long-term investors to be used for interactive classroom teaching.

Newton has been a long-term supporter of the Centre. We believe in the importance of academic research and the potential for long-term value creation through bridging the gaps between research, practice and policy.

Find out more about the Cambridge Judge Business School (at www.jbs.cam.ac.uk) and the Centre for Endowment Asset Management (at www.ceam.jbs.cam.ac.uk)



To assess the value of active engagement, it is instructive to look at which firms are being engaged, how these engagements are executed in practice, and the likelihood of an engagement being successful. The *Active Ownership* study explored each of these areas.

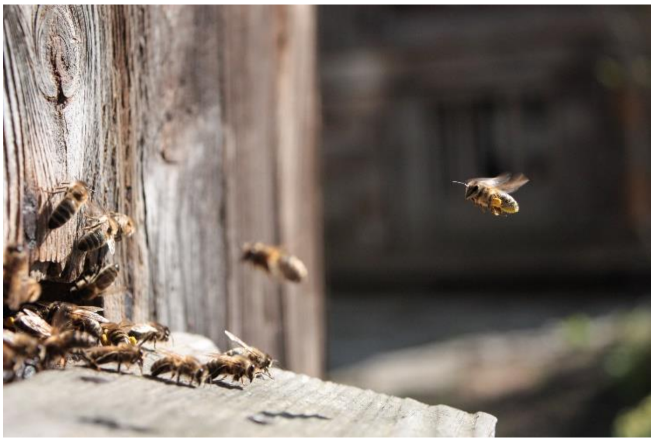
The sample in the study covered 2,152 engagement sequences in 613 public US companies between 1999 and 2009. The rate of success was 18%, and it required an average of two to three engagements before success was achieved. Typically, the time between initial engagement and success being recorded was 1.5 years, with a median of one year. The 2,152 engagements were split into 1,252 environment and social (ES) sequences and 900 corporate governance

[1]https://www.unpri.org/pri/what-is-responsible-investment
[2]https://app.powerbi.com/view?r=eyJrIjoiZjA2OTA5MWUtMzc4OC00MTZhLWIyZDYtYTc3NDMzOGE1OGFjIiwidCI6ImZiYzI1NzBkLWE5OGYtNDFmMS1hOGFkLTEyYjEzMWJkOTNlOCIsImMiOjh9
[3] http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf
[4] Goldstein, 2011
[5] https://www.unglobalcompact.org/participation/join/commitment

(CG) sequences. Compared to CG themes, there tended to be more engagements per sequence for ES cases (3.7 vs 2.2), although the chance of achieving success in the ES cases was lower (13% vs 24%).

Certain factors made a successful engagement more likely. If the target company had either reputational concerns, the capacity to make changes, economies of scale or headroom for improvement, it was more likely that engaging with this company would have a positive outcome. In terms of environmental and social engagements, concerns over reputation and capacity to change played a bigger role in determining success.

The study found that, on average, ESG engagements resulted in a cumulative size-adjusted abnormal return of +2.3% over the year following the initial engagement. For successful engagement, an abnormal return of +7.1% was observed. The return patterns and magnitudes were similar when comparing ES and CG engagement specifically. Significantly, the study did not find any market reaction (adverse or otherwise) to unsuccessful engagements.



While these figures are encouraging, it is important to note that there were some differences between the ES and CG subsamples. The data suggest there is a more pronounced positive effect on the return on assets and the ratio of sales to the number of employees after successful ES engagements, compared with the effects of successful CG engagements (although a positive impact is seen in relation to both areas). This suggests that improved ESG practices augment customer and employee loyalty, but to a greater extent in ES engagements. ES engagements also appear to generate a clientele effect among shareholders – an impact which is not observed in CG engagements. However, in both subsamples of ESG engagements, improvements are seen in the corporate governance structure of targeted firms, suggesting that improved ESG practices strengthen governance quality.

In this study, there were two types of engagements **– raising awareness** and **request for change**. Raising awareness involves informing the firm about certain ESG issues in their company, whereas requesting change tends to be a more active and concrete mode of engagement, in which the asset manager requests specific changes in order to address an ESG issue. There are also two types of collaborations: ‘hard’ and ‘soft’. Hard collaborations refer to situations in which the asset manager works with activist investors, including SRI funds and financial institutions, among others. Soft collaborations occur when the asset manager uses ESG principles and initiatives that have been independently established by the industry, or by non-profit or investment bodies.

The firms selected for engagement in the study had some common characteristics. They tended to be large, mature firms with socially conscious investors and they typically paid higher dividends and had high customer loyalty.

The study findings suggest that asset managers select differently for CG and ES engagements. For CG engagements, mature firms with poor corporate governance tended to be chosen, while for ES engagements, large companies with reputational concerns were better targets.

It is useful to know which target characteristics are likely to support successful engagement. The study shows that firms with poor performance and pronounced reputational concerns are likely to benefit most from ESG engagements. It also indicates that CG engagements tend to be more successful with larger, more established firms.

The study finds that companies that are less financially constrained are associated with higher levels of success. This is consistent with the findings of another study which shows that making changes to improve ESG quality tends to be costly.[6] The correlation between a company's financial position and successful engagement is pronounced for ES engagements, which are more likely to engender success (compared with CG engagements) if the target firm spends less on research and development, spends more on advertising, and has lower shareholdings from the asset manager and SRI funds. These findings are consistent with the idea that ES engagements are costly, and with the notion that success depends on reputational concerns and the asset manager’s collaborations with other investors.

The study found evidence to suggest that the number of lawsuits is also an indicator of a successful engagement, as firms facing legal pressure are more likely to make changes in their approach to ESG issues. It also notes that firms can embrace ESG considerations as a strategic opportunity, based on demands from shareholders and the public.

When considering successful climate change engagements, the achievement of positive abnormal returns suggests that investors expect ESG changes to increase firm value. In further support of this theory, Bauer and Hann (2014)[7] show that companies which actively engaged with environmental issues, particularly climate change, tended to have a lower cost of debt. Chava (2014)[8] also found that firms with unaddressed environmental issues had a higher cost of capital. These results suggest that ESG engagement, especially with regard to climate change, can be good for the bottom line.

After examining the impact of ESG engagement on target firms (and the factors that are more likely to result in the engagement being successful), the *Active Ownership* study turns to consider how successful ESG engagements could lead to a favourable stock-market response. Prior research suggests that by attracting more socially conscious customers and shareholders, increasing the loyalty of customers and employees, and suggesting a commitment to further improvement, ESG activism could positively impact share-price performance.

However, the question remains whether a causal link can be drawn between active engagement and ensuing corporate performance. Might improved performance be illusory? One theory suggests that engaged companies may be self-filtering engagement proposals and rejecting value-destructive propositions, despite them being suggested by the asset manager. However, the data do not suggest that management filtering in target companies skews the positive impact of ESG engagements.

There is also a theory that suggests ‘reverse causality’ may be contributing to illusory improvements, by which a firm waits until there is evidence to suggest that its stock price will increase as a result of the proposed ESG activism and then makes the change. However, the data do not suggest that ESG improvements are a consequence of anticipated positive future performance. The final possibility considered by the paper is that milestones are recorded retrospectively, after a positive stock-market reaction. However, a significant portion of the milestones correspond with shareholder meetings, and some further analysis shows that this possibility is unlikely. The study reasserts that the data demonstrates a positive abnormal return for successful engagements and a zero return for unsuccessful ones, and concludes therefore that the risk is limited in ESG engagements given the potential pay-off.

Given that ESG engagement has been shown to improve shareholder value, the study goes on to ask why firms do not voluntarily try to improve their ESG practices. While it is possible for a firm to address its ESG issues in the absence of intervention, it is unlikely. Target firms were shown to have poorer corporate governance than unengaged firms, which results in effective changes being difficult to pursue in these target firms. Active owners also provide guidance and direction to target firms. Without this guidance, many companies are likely to struggle to identify and respond to ESG issues in a timely and effective manner. The asset manager – in collaboration with other stakeholders – creates a productive environment for target firms to address their ESG concerns.

[6]Hong, H., J. D. Kubik, and J. Scheinkman. 2012. Financial constraints on corporate goodness. Working paper no. 18476, NBER.
[7] Bauer, R., and D. Hann. 2014. Corporate environmental management and credit risk. Working Paper, The European Centre for Corporate Engagement.
[8] Chava, S. 2014. Environmental externalities and cost of capital. *Management Science* 60:2223-47.

CONCLUSION

Based on data collected from active-ownership engagements in US public firms between 1999-2009, the study found positive market reactions to ESG engagements. On average, the ESG engagement gave rise to a positive size-adjusted abnormal return of +2.3% over the year following the initial engagement. The average one-year size-adjusted abnormal return after initial engagement was +7.1% for successful engagements, but there was no adverse reaction to unsuccessful engagements. In short, the study suggests there is a lot to gain, but little to lose, from active engagement.

The positive returns were most significant for engagements that related to corporate governance and climate change. Compared to control companies, firms with poorer performance, inferior governance structure, more significant reputational concerns and higher shareholding from the asset manager were more likely to be chosen as target firms. Within these target firms, companies with greater reputational concerns and the financial and logistical capacity for improvement were more likely to have successful engagements. After successful engagements (especially successful ES engagements), firms tended to note improved performance in their operations, profitability, efficiency, shareholding and governance.

While these findings look very positive, it is important to consider the limitations of the work. The abnormal returns observed may be specific to this time period, as market conditions and sentiment vary over time. As awareness of ESG issues becomes more prominent, improvements from active engagement may be diminished. The study provides the first detailed exploration of the impact of engagement. Further research into the precise mechanisms that determine price reaction to engagements would be beneficial, as would exploration of whether the results are reflected in other markets around the world.

However, the *Active Ownership* study clearly shows that successful ESG engagements can have a positive impact on returns, with very limited risk if an engagement in unsuccessful. This illustrates the value of active engagement not just for society, but for firms and shareholders too.

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