PRI Principles for Responsible Investment

Co-funded by the European Commission

Why be an active owner?

Investors have the ability, by working individually or collaboratively with other investors, to influence the behaviour of companies and other entities in which they are invested through, for example, encouraging these companies and other entities to improve their management systems, performance issues and reporting on environmental, social and governance (ESG) these issues. Engagement with public policy makers is increasingly seen as an integral part of active ownership.

The Rationale for Being an Active Owner

There are various reasons for investors to be active owners and to use their influence to encourage high standards of ESG performance in the companies and other entities in which they are invested. These include:

- The recognition that sustainability (or ESG) issues are important drivers of investment value, and that a failure to effectively manage them can destroy investment value.
- The recognition that ensuring that social, environmental and economic systems are stable, well-functioning and well governed is important to the delivery of good investment returns.
- The need to meet the demands of clients, regulators and other stakeholders.
- The belief that investors have ethical responsibilities to address the ESG-related issues and impacts associated with their investments.

Different investors will attach different weight to these various factors.

The Effectiveness of Active Ownership

Investors influence company performance on ESG issues in a variety of ways, including through the price and market signals resulting from their investment activities, through the manner in which they cast their votes and use the other formal rights granted to them as investors, through individual or collaborative dialogues with companies, through their ability to impact on companies' brand or reputation, and through their influence on public policy.

There is a growing literature on the ESG and financial outcomes that result from investor action. The areas where investors are most likely to be effective are in relation to:

- Governance: Investors have a clear interest in ensuring that the companies in which they invest, on behalf of their beneficiaries or clients, are run in investors' interests (not in the interests of company management) and will frequently commit significant resources to ensuring that this is the case.

- Risk management: Investors have played an important role in encouraging companies to acknowledge ESG issues as important and to implement policies, systems and processes to ensure that these are managed effectively.
- Disclosure: Investors have played a major role in encouraging companies to prepare CSR or sustainability reports and in getting many companies to report to initiatives such as the Carbon Disclosure Project. Many investors see good disclosure on ESG issues as an integral part of the effective functioning of investment markets.
- Financial returns: Recent research is finding that 'high sustainability' companies significantly outperform their counterparts over the long term, both in terms of stock market and accounting performance.[1] Other research has found that companies subject to engagement on corporate governance and climate change show significant financial outperformance of the market in the period following engagement.[2]

Investors have been much less effective (i.e. have struggled to get companies to change) in situations where the business case for action is less clear cut and/or where the perceived costs of taking action outweigh the perceived benefits. In these situations, investors have made progress through encouraging companies to take a longer-term and more holistic view of their businesses, by working collaboratively with other investors, and through encouraging policymakers to take action on the issue in question. To date, this has been most clearly seen in the work that the investor networks on climate change (the Institutional Investors Group on Climate Change and others) and the PRI have done to signal to governments that they are supportive of effective policy action on climate change, even if this may impose costs on some companies.

Some Practical Considerations

From a practical perspective, there is a whole series of factors that influence the approach that individual organisations adopt to active ownership. These include (acknowledging that there is significant overlap between these elements):

- Their views on issues such as the implications of sustainability-related issues and market stability-related issues for the long-term value of their investments and the potential for active ownership to protect or enhance investment returns over the short, medium and long term.
- The resources (human, financial) that they allocate to responsible investment and active ownership.
- The level of client demand for active ownership.
- The pressure from regulators, policy makers and other stakeholders for investors to play an active role in ensuring that the companies in which they are invested are well governed and

[1] The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance - Robert G. Eccles, Ioannis Ioannou and George Serafeim, Harvard Business School, November 2011
[2] Active Ownership – Dimson, Karakas, Li, 2012

have good standards of social and environmental performance.
- The views of the investment industry as a whole. The PRI has played an important role in raising awareness of responsible investment and, through its signatory reporting requirements, creating pressure for all investors to improve their practices and processes.

Can the Contribution of Active Ownership be Measured?

One of the key challenges in this area is demonstrating that the actions taken by investors have had an impact on corporate practices or performance. The challenge is one of attribution. It is possible for investors to gather and report information on:

- Their own processes and actions. This can include information on, for instance, the resources they have committed to engagement and the activities they have conducted (e.g. the number of meetings they have had with companies, the issues they have raised).
- The visibility and awareness-raising outcomes they have achieved. Examples could include the number of investors they have persuaded to sign a letter and the level of press coverage they have achieved.
- The changes that have occurred in corporate practice or performance. For example, it is often possible to point to companies taking certain actions (e.g. adopting a policy, starting to report on performance) and achieving certain outcomes (e.g. reductions in reported emissions).

However, it is extremely difficult for investors to claim that it was their actions or interventions that were critical in companies' decisions to take these steps. There are various reasons: companies are reluctant to acknowledge that outside parties drove them to act in a particular way, there are generally multiple pressures for companies to take action (e.g. it is often the case that other investors and other stakeholders have also been pressing the company to take action), the company may well have been in the process of taking action anyway, or the outcomes may have resulted simply as a result of the normal evolution of the business.

Acknowledging the issue of attribution, developing a clearer understanding of the relationship between investor action and corporate ESG performance is an important challenge for the responsible investment industry. Clients are starting to ask questions about the outcomes that result from active ownership and, more widely, stakeholders are starting to challenge investors to demonstrate that responsible investment (in particular, investment integration and active ownership) provide real benefits in terms of ESG outcomes.

The PRI's new Reporting Framework, which all PRI signatories will be required to report against from 2014 onwards, will help to address these questions. The framework will ask PRI signatories to report on the actions they have taken, the manner in which they measure ESG and financial performance outcomes, and the outcomes that they think have resulted from their responsible investment activities. While the problem of attribution at the individual investor level is likely to remain, this reporting will at least provide support for the high-level argument that there are real ESG benefits to active ownership and responsible investment.

References/Further Reading

Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas (2008), 'The Returns to Hedge Fund Activism', *ECGI Law Working Paper N°.098/2008*, http://ssrn.com/abstract=1111778

Macro Becht, Julian Franks, Colin Mayer and Stefano Rossi (2009), 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Funds', *The Review of Financial Studies,* Vol. 22, No. 8, pp. 3093- 3129.

William Carleton, James Nelson and Michael Weisbach (1998), 'The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF', *Journal of Finance*, Vol. 23, No. 4, pp. 1335- 1363.

Elroy Dimson, Oguzhan Karakas & Xi Li (2012), 'Activism on Corporate Social Responsibility', http://www.inquire-europe.org/research.html

Financial Reporting Council (2011) *Developments in Corporate Governance 2011: The impact and implementation of the UK Corporate Governance and Stewardship Codes* (FRC, London).

James Gifford (2010), 'Effective Shareholder Engagement: The Factors that Contribute to Shareholder Salience', *Journal of Business Ethics*, 92, pp. 79-97.

PRI ESG Working Group Report (Feb 2013), *Integrated Analysis: How investors are addressing environmental, social and governance factors in fundamental equity valuations* (PRI, London)

PRI Clearinghouse publication on collaborative engagement (report due mid 2013)

Rory Sullivan and Craig Mackenzie (eds.) (2006), *Responsible Investment* (Greenleaf Publishing, Sheffield, UK).