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Investment Institute

Investing with impact through active ownership

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A letter to investors

The past decade has witnessed a sea change in investor perceptions about corporate engagement efforts. While some organizations have engagement efforts that reach back decades, in the past ten years these initiatives have been adopted across the industry, due in part to commitments made under the United Nations-supported Principles for Responsible Investment. This has led to both a broadening and deepening of active ownership initiatives, from the corporate governance efforts of activist hedge funds, to institutional investor programs seeking improved Environmental, Social, and Governance (ESG) disclosure, to coordinated global engagements encouraging better corporate performance in areas of systemic risk, particularly climate change and human capital.

One of the biggest surprises in recent years has been the academic finding that corporate engagement efforts are more than just talk: they appear to genuinely influence corporate behavior. Some studies find evidence of positive changes in financial performance, as well as measurable impacts on stock prices.

At Wells Fargo and Company, we've always taken our commitment to stewardship seriously, and teams in our investment organization work every day to ensure that the companies we invest in meet global standards for corporate governance, ESG disclosure, and management of systematic risk. As the report that follows demonstrates, this is a field with a long history and a very bright future. We are excited to be a part of it.

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Senior Portfolio Manager,
Head of Social Impact Investing for
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"In South Africa, we could not have achieved our freedom and just peace without the help of people around the world, who through the use of nonviolent means, such as boycotts and divestment, encouraged their governments and other corporate actors to reverse decades-long support for the Apartheid regime."

– Desmond Tutu, Archbishop Emeritus of Cape Town[1]

1. "Divesting from Injustice," Archbishop Emeritus Desmond Tutu, Huffpost, June 13, 2010.

The role of active ownership

Global demand for responsible and sustainable investing has expanded rapidly over the past decade. What was once seen as a niche market driven primarily by faith-based institutions and individual investors seeking to align their investments with their values has grown significantly to include many institutional investors. The result has been the development of new techniques and more widespread consideration of environmental, social, and governance (ESG) factors in the investment process. At the close of 2020, 1 in 3 dollars of professionally managed money in the U.S. (approximately $17.1 trillion)[1] was invested in strategies employing ESG techniques. Though the strategies of ESG investors continue to develop, one of their primary goals has remained consistent: to effect positive change through the capital markets while seeking competitive investment returns. In this paper we take a deeper look at the tools used by active investment owners to help create positive impact.

The Quakers, South Africa, and the beginning of active owners

History has shown that active owners can play a role in influencing global and domestic issues. In the 18th century, the Quakers pressured their members to free their slaves and divest from the slave trade, and played a key role in persuading the United Kingdom to end the international slave trade in 1807.

More recently, corporate pressure was one of the factors that led to the end of apartheid. In 1977, Reverend Leon Sullivan developed the Sullivan Principles, which called for companies operating in South Africa to directly improve working conditions by adopting such practices as non-segregation of the races and equal pay. Several corporations adopted the principles, but the South African government remained resistant, so the anti-apartheid campaign moved to corporate divestment in the 1980s. The increasingly successful divestment campaign was a major factor in the end of apartheid in the early 1990s.

An oil spill, the rise of ESG reporting, and the development of active investing

The modern sustainable investing movement was born in the wake of the tragedy of the Exxon Valdez Oil Spill in 1989. Considered one of the worst oil spills ever in terms of environmental damage, Exxon Valdez inspired investment manager Joan Bavaria to found Ceres, a nonprofit which aims to standardize corporate reporting on environmental goals, and later the Global Reporting Initiative (GRI), which is now the most widely used framework for corporate sustainability reporting.

Subsequent years also saw the emergence of other reporting frameworks and tools; such as CDP (formerly the Carbon Disclosure Project), to help companies disclose information on climate risk and emissions; and the Sustainability Accounting Standards Board (SASB), which develops industry-specific standards focused on financially material ESG topics.

These frameworks facilitate an increase in ESG data availability that help investors move beyond just excluding companies from their portfolios based on their involvement in certain activities (such as tobacco, gambling, and pornography) and help determine which companies are considered best in class among their peers. Investors now have the tools to also monitor and engage with companies on ESG issues, as codified in the Principles for Responsible Investing (see page 5), in an effort to improve the ESG profile of companies they hold. This may result in investing in companies that perform better over the long term.

1. U.S. SIF Foundation 2020 Sustainable and Impact Investing Trends Report

Responsible investing — the next step in corporate engagement

Signatories to the Principles for Responsible Investing (PRI) commit to be active owners and to incorporate ESG issues into their ownership policies and practices. As of March 2020, the UN-supported initiative had 3,038 signatories representing $103.4 trillion in assets under management.[2] Of the six principles below, the second principle applies most directly to active ownership.

6 Principles of Responsible Investing

1 We will incorporate ESG issues into investment analysis and decision-making processes.

2 We will be ***active owners*** and incorporate ESG issues into our ownership policies and practices. Possible actions:

- Develop and disclose an active ownership policy consistent with the Principles.
- Exercise voting rights or monitor compliance with voting policy (if outsourced).
- Participate in the development of policy, regulation, and standard setting (such as promoting and protecting shareholder rights).
- File shareholder resolutions consistent with long-term ESG considerations.
- Engage with companies on ESG issues.
- Ask investment managers to undertake and report on ESG-related engagement.

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4 We will promote acceptance and implementation of the Principles within the investment industry.

5 We will work together to enhance our effectiveness in implementing the Principles.

6 We will each report on our activities and progress towards implementing the Principles.[3]

2. https://www.unpri.org/download?ac=11599
3. https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment

The tools of active ownership

Dialogue

Responsible investors often use the language of stewardship, seeing themselves as long-term owners serving both current and future generations. Nurturing a constructive dialogue with companies has the potential to not only improve long-term financial performance, but also to benefit society and the environment at large. Investors can bring detailed expertise to particular aspects of a company's business — such as air emissions or diversity reporting — and work with companies to address shortcomings or blind spots in their ESG profile.

The dialogue between an asset manager and a company typically follows a different course than that between a company and an advocacy group. Advocacy groups tend to have certain issues that they wish to promote, regardless of the impact to the company's business. By contrast, active owners tend to prefer a win-win approach, considering the business impact to the company as well as the impact to society and the environment. Such a collaborative approach is more likely to achieve management buy-in, which helps the dialogue to be successful.

Proxy voting — the institutional perspective

Proxy voting in the U.S. is dominated by institutional investors — such as mutual funds, index funds, pension funds, and hedge funds — which own approximately 70% of the outstanding shares of publicly traded companies. (Individual investors own the other 30%.) Institutional investors also have higher voting participation rates, casting votes for 91% of the shares that they hold, versus only 29% for individual investors. While large institutional investors such as BlackRock, Inc. and Capital Group (advisor to the American Funds) have the time and resources to develop their own proprietary guidelines for proxy voting, most small and mid-sized institutional investors rely on the services of third-party advisors such as Institutional Shareholder Services Inc. (ISS) and Glass Lewis & Co. LLC. Using these voting guidelines allows investors to cost-effectively satisfy their fiduciary and regulatory obligations to vote their shares on behalf of their clients. Researchers at George Mason University estimate that these two firms combined have a 97% market share.[4] This suggests that proxy advisory firms have notable influence over proxy voting outcomes.

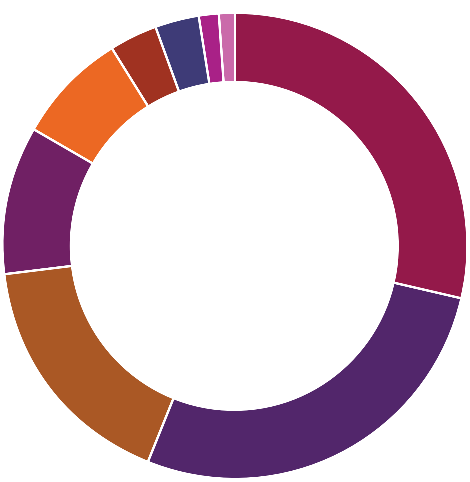
Shareholder resolutions are mainly filed by faith-based investors, money managers, and foundations[5]

During the 2018-2020 proxy seasons, 149 institutional investors and 56 investment managers filed or co-filed shareholder resolutions on ESG, representing $1.98 trillion in assets at the start of 2020.

The power of proxy

Proxy voting is a fundamental tool of company engagement in that common stock shareholders are exercising one of the rights of ownership.

Take director elections — an investor who believes that the board of directors should be more diverse could withhold votes from non-diverse board candidates, or from the Chair of the Governance and Nominating Committee.
In addition, investors can vote on shareholder resolutions that may redirect the course of a company. Even though most proxy resolutions are nonbinding, they can create awareness that leads to concrete changes. The main disadvantage of the shareholder voting process is that it only occurs once a year, at the corporation's annual meeting, though investors will often pair proxy voting with year-round dialogue.



- Faith-based **28.8%**
- Money manager **27.3%**
- Foundation **17.1%**
- Public **10.2%**
- Labor **7.8%**
- Other/Nonprofit **3.4%**
- Healthcare **2.9%**
- Family office **1.4%**
- Education **1.0%**

Source: U.S. SIF Foundation

4. https://corpgov.law.harvard.edu/2018/06/14/the-big-thumb-on-the-scale-an-overview-of-the-proxy-advisory-industry/#:~:text=The%20influence%20of%20ISS%20and%20Glass%20Lewis%20is,ISS%20recommendations%20on%20proxy%20voting%20across%20governance%20issues.

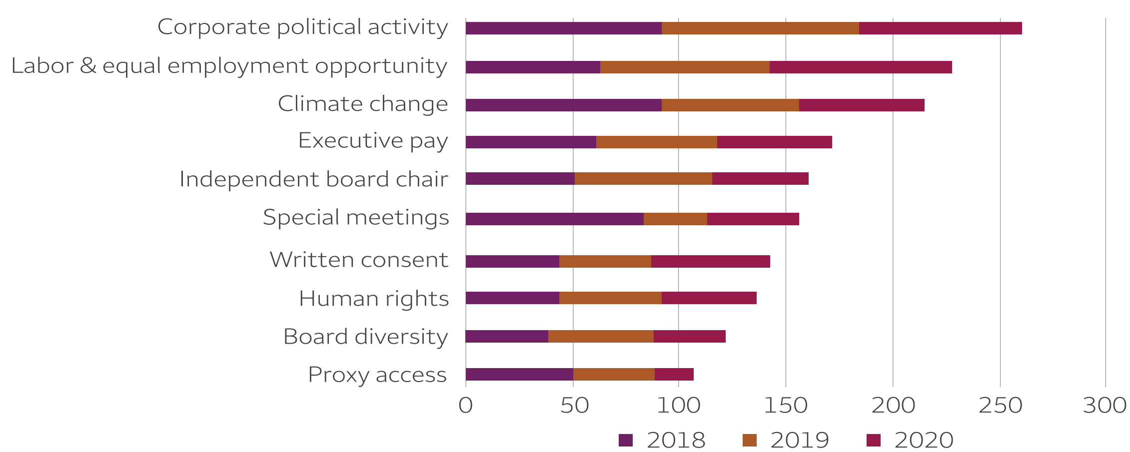
5. U.S. Foundation, Report on US Sustainable and Impact Investing Trends 2020, pg. 74.

Filing resolutions

Just as shareholders have the right to vote on corporate business, they also have the right to propose resolutions. Shareholder resolutions are more often filed by religious organizations, money managers, and foundations. Resolutions often succeed or fail based on their level of institutional support. Strong shareholder support for resolutions may lead to better disclosure or improved practices. A study that examined shareholder resolutions over 10 years found that proposals "…that ask for greater transparency have a high propensity to generate greater CSR [corporate social responsibility] disclosure by firm."[6]

Shareholder resolutions over the past three years have focused on political activity, human capital and climate[7]

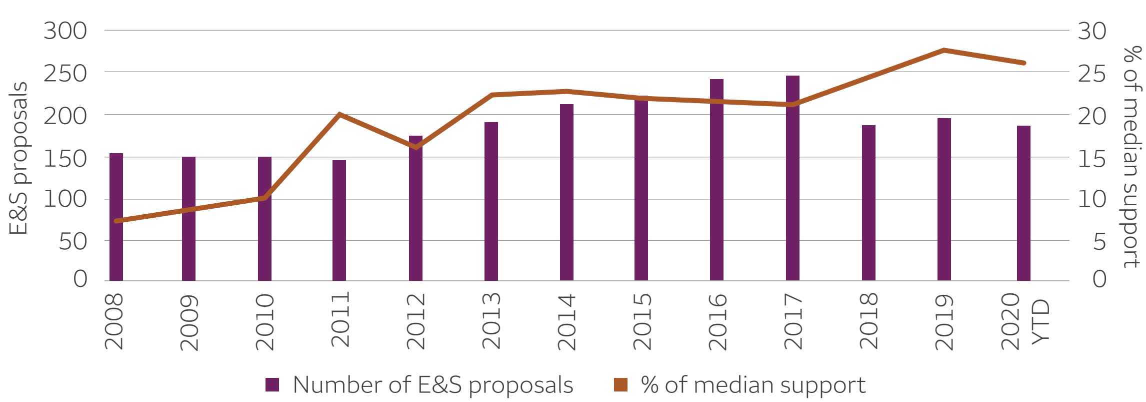
During the 2018-2020 proxy seasons, 270 ESG shareholder resolutions were filed at U.S.-listed companies on the topic of political activity, 228 on human capital issues such as fair labor and equal employment opportunity, and 217 on climate change.



Source: U.S. SIF Foundation

Environmental and social (E&S) shareholder resolutions

The following chart shows the number of resolutions filed annually at U.S.-listed companies has remained relatively stable, while the percent of shareholder support has increased over time.[8]



Data source: Institutional Shareholder Services (ISS)

6. "Shareholder Engagement on Environmental, Social, and Governance Performance, " Barko, Tamas; Martijn Cremers; and Luc Renneboog. Posted May 31, 2017; last revised September 5, 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2977219.

7. U.S. Foundation, Report on US Sustainable and Impact Investing Trends 2020, pg. 74.

8. ISS U.S. Environmental & Social Shareholder Proposals 2020 PROXY SEASON REVIEW, pp. 5-6.

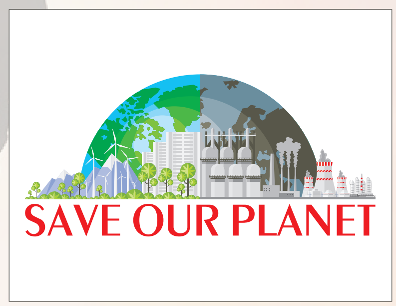
Divestment

Divestment campaigns are one of the oldest and more confrontational ways to achieve a particular goal, dating back to the Quaker's long campaign first against the slave trade and then the continuing existence of slavery in the 18th and 19th centuries. Such campaigns pressure companies to withdraw their operations from particular industries or countries or persuade shareholders to sell shares in targeted companies.

Unlike other active ownership tools, in which the goal is to negotiate with the company, divestment campaigns typically occur when the clients' or the firm's values are fundamentally opposed to the business's operations. For example, oil and gas divestment campaigns might have the explicit goals of decreasing the stock prices of oil and gas companies and increasing their cost of capital. In some cases, however, divestment campaigns reflect a desire to reduce financial harm, such as the risk of stranded assets in the oil and gas industry or potential regulatory threats in the tobacco industry.

Divestment campaigns

Divestment campaigns are often accompanied by sustained public relations campaigns aimed at gaining widespread support, such as with the decades-long campaign against apartheid, and the recent climate change campaign led by author Bill McKibben and 350.org to encourage investors to divest from fossil fuels.



Achieving impact through investing

Research indicates that engaged investors may improve companies' long-term financial results. A 10-year study of corporate engagements with U.S. public companies found that successful engagements, particularly on environmental and social issues, led to improved financial performance and corporate governance, as well as increased institutional ownership.[9] Likewise, the efforts of California Public Employees' Retirement System (CalPERS), one of the largest pension funds in the United States, to lobby for better governance practices from companies it perceived as laggards "has resulted in total wealth creation of $3.1 billion between 1992 and 2005."[10]

The work of standardization received a major boost in October 2018, when the Sustainability Accounting Standards Board (SASB) published a set of industry-specific ESG accounting standards designed to assist companies in disclosing financially material, decision-useful sustainability information. The SASB Standards are especially helpful to investors because they were developed based on feedback from thousands of investors and companies.

What gets measured gets done

Disclosure is necessary to determine whether a company is an ESG leader or laggard. However, companies report using a variety of metrics, making comparisons difficult. As a result, investors rely on third-party vendors — such as Sustainalytics and MSCI Inc. — that rate companies based on topics likely to effect long-term financial performance. Such topics include climate change, human capital, corporate governance, and industry-specific factors such as infrastructure safety in the utilities sector.

The future of active ownership

Just as active ownership contributed to ending apartheid in South Africa many decades ago, the active owners of today are still seeking to drive change. Take, for example, The 2030 Agenda for Sustainable Development, which was adopted in 2015 by all member states of the United Nations. The agenda consists of 17 Sustainable Development Goals (SDGs) aimed at ending poverty, improving health and education, reducing inequality, increasing economic growth, addressing climate change, and preserving the environment. Achieving progress on such lofty goals will require not only action from governments and nonprofit organizations, but also action from corporations. The Sustainable Development Goals (SDGs) have become a rallying cry for active owners working to engage companies to achieve positive outcomes for both shareholders and the world we live in. Thus, by utilizing the tools of active ownership, investors have the opportunity to effect positive change, while preserving the potential to earn market-like returns.

9. Dimson, Elroy, Oğuzhan Karakaş, and Xi Li. "Active Ownership." The Review of Financial Studies, vol. 28, issue 12, December 2015, pp. 3225-3268.

10. Barber, Brad M. "Monitoring the Monitor: Evaluating CalPERS' Activism." The Journal of Investing, Winter 2007, 16 (4), pp. 66-80.

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Disclosures

RISK CONSIDERATIONS

All investing involves some degree of risk, whether it is associated with market volatility, purchasing power or a specific security. There is no assurance any investment strategy will be successful. Asset allocation does not guarantee a profit or protect against loss.

Sustainable' or 'Social Impact' investing focuses on companies that demonstrate adherence to environmental, social and corporate governance (ESG) principles, among other values. There is no assurance that social impact investing can be an effective strategy under all market conditions or that a strategy's holdings will exhibit positive or favorable ESG characteristics. Different investment styles tend to shift in and out of favor. In addition, an investment's social policy could cause it to forgo opportunities to gain exposure to certain industries, companies, sectors or regions of the economy which could cause it to underperform similar portfolios that do not have a social policy. Risks associated with investing in ESG-related strategies can also include a lack of consistency in approach and a lack of transparency in manager methodologies. In addition, some ESG investments may be dependent on government tax incentives and subsidies and on political support for certain environmental technologies and companies. The ESG sector also may have challenges such as a limited number of issuers and liquidity in the market, including a robust secondary market.
There are many factors to consider when choosing an investment portfolio and ESG data is only one component to potentially consider. Investors should not place undue reliance on ESG principles when selecting an investment.

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