SMART engagement: A hybrid approach to non-sustainable companies

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INTRODUCTION

Sustainable investment has undergone several evolutions over the past decade. Norms-based screening was arguably the first stage, followed by the integration of Environmental, Social, and Corporate Governance (ESG) issues in investment analysis, which required a more case-by-case approach and deeper data needs. Both these strategies are considered "outside-in": ESG factors are taken into account because of their impact on an investor – be it via reputational risk or affecting the risk/return profile of the investee company. These can be referred to as "2-D" strategies because their primary concern, even when taking into account sustainability factors, is risk and return.

Increasingly, institutional investors are being asked to account for impact on the real world, leading to the expression "3-D investing" (risk, return, and impact) (Blitz et al, 2024; Schoenmaker and Schramade, 2023). A survey conducted by the Global Impact Investing Network (2023) shows that impact assets under management have grown at a compound annual growth rate of 18% between 2017 and 2022, with pension funds and insurance companies representing the fastest-growing source of funding for impact investment managers. In Europe, this was reinforced in 2023 by the EU Taxonomy, which defines which economic activities can be considered environmentally sustainable, and the Corporate Sustainability Reporting Directive (CSRD) and Sustainable Finance Disclosure Regulation (SFDR), which sets out how out how financial corporates and financial market participants must disclose sustainability information, respectively. The goal is to encourage more capital to be directed to "sustainable" companies, that is companies from sectors that are associated with positive social and/or environmental outcomes. But what about "non-sustainable" companies, which are those that are from sectors that an investor feels have had negative social or environmental outcomes? Do these have a place in the portfolio of a 3-D investor?

In this article, we will examine the two options available to deal with non-sustainable companies and explore a hybrid approach for aspiring 3-D investors. We will use as a case study the recent oil and gas engagement program of a Dutch based pension fund, which was implemented by its investment manager.

TWO MAIN APPROACHES TO NON-SUSTAINABLE COMPANIES

Investors that seek to manage the sustainability of their portfolios have typically responded in one of two ways when confronted with non-sustainable companies: Blanket divestment or

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perpetual engagement (Broccardo, Hart and Zingales, 2022). The former is a widely used approach to avoid the reputational risks associated with remaining invested in non-sustainable companies. Capital owners and end-beneficiaries may also not want their capital and savings invested in certain sectors because they are contrary to their values (e.g., divesting tobacco companies from a healthcare pension fund). While this can insulate an investor from reputational risks, divestment does not necessarily have a direct impact on the companies being divested. A study by Ansar et al. (2013) suggests that while the oil and gas divestment movement may stigmatize the industry, it is unlikely to have a meaningful direct effect on the share prices of companies (see also Berk and Van Binsbergen, 2022). In fact, one could argue that divestment may even lead to worsening standards if sustainable investors sell shares to investors that care less about climate change and challenge management of such companies less. For 3-D investors that are concerned about real world impact, this is problematic.

THE MAINSTREAM STRATEGIES TO DEAL WITH NON-SUSTAINABLE COMPANIES (BLANKET DIVESTMENT AND PERPETUAL ENGAGEMENT), APPEAR TO CONFLICT WITH THE MANDATE OF "3-D" INVESTORS

Instead of divestment, sustainable investors could choose to engage with non-sustainable companies to encourage them to improve their sustainability performance, which has the potential to achieve real world impact (Kölbel et al, 2020). Under the umbrella of the Climate Action 100+ initiative, around 700 investors are engaging 170 of the world's most carbon intensive companies. Notable developments that have occurred during engagements include Volkswagen publishing a climate lobbying report and Petróleo Brasileiro setting a commitment to become net zero by 2050 for its operational emissions (Climate Action 100+, 2023). However, as of October 2023, six years after the initiative's launch, only 13% of target companies had set a mid-term target aligned with 1.5C warming pathway (Climate Action 100+, 2023). Engagement can theoretically be a force for real world impact, but success is far from guaranteed, and investors may be accused of 'engagement washing', that is, using perpetual engagement as a smokescreen to remain invested in non-sustainable companies but still attract impact-focused clients. This is again problematic for 3-D investors.

SMART ENGAGEMENT

For aspiring 3-D investors hoping to overcome the shortcomings of the mainstream approaches (that is divestment and perpetual engagement), we recommend considering the engagement route whilst making that approach Specific, Measurable, Achievable, Relevant, and Timebound (SMART). This will help show that an investor prioritizes impact and improves the legitimacy of their approach. These benefits are discussed in the next section. The first four of the SMART components refer to the milestones and overall objective of the engagement and the last refers to the timeline and consequences of failure. The SMART approach is explained using the oil and gas engagement program of a Dutch based pension fund, which took place from 2022-2023.

1. OBJECTIVES ARE SPECIFIC

The overall objective of an engagement should be clear and not open to interpretation. In the case of the oil and gas program, it was expected that companies would implement a transition plan that demonstrates that the company is contributing to the Paris Agreement goal. Furthermore, intermediate engagement milestones should be set that will lead to the desired outcome. Milestones should be specific, build on one another, and increase in ambition over time.

In the case of the oil and gas program, two additional intermediate goals were set: 1) Oil and gas companies were expected to first set any kind of greenhouse gas emissions target; and 2) Companies were subsequently expected to publicly commit to net zero by 2050.

2. OUTCOMES AND INPUTS ARE MEASURABLE

The achievement or non-achievement of milestones and the overall engagement objective should be indisputable. Actions and commitments should be publicly available and accessible to all investors and recorded in public documentation. The increasing availability of carbon data, climate transition plans, and third-party standards such as the Taskforce for Climate-Related Financial Disclosure (TCFD)[1] have made this easier.

ENGAGEMENT CAN THEORETICALLY BE A FORCE FOR REAL WORLD IMPACT, BUT SUCCESS IS FAR FROM GUARANTEED, AND INVESTORS MAY BE ACCUSED OF 'ENGAGEMENT WASHING'

Besides the measurability of company performance, it is important that investors are transparent about investor contribution. Free riding is a common problem in engagement, as many investors can claim credit for a company making progress. To avoid these accusations, it is important the investors are transparent to their stakeholders about what they are asking of companies, as mentioned in the 'specific' step, and avoid claiming direct causality.

3. OBJECTIVES ARE ACHIEVABLE

The overall engagement objective and the intermediate milestones should be ambitious and in line with the client's mandate. However, engagement objectives and milestones should also be achievable by investee companies.

During the oil and gas program, there was a lack of agreement in the investor community on how to determine if a company's strategy was considered "Paris aligned". To further complicate matters, it was challenging to expect oil and gas companies to strictly follow net zero scenarios if their customers were not doing so. In the International Energy Agency's (IEA) Net Zero Emissions (NZE) scenario, the oil and gas industry is expected to cut oil and gas production by 28% and 7%, respectively, by 2030 vs. 2019. But these targets are contingent on fossil fuel demand reduction and aggressive policy response, hence not deemed appropriate to use them in assessment criteria.

Instead, the core expectation for oil and gas companies in the program was that at least 30% of their energy mix by 2030 should come from low carbon sources (for example solar, wind, bioenergy, and green hydrogen). This energy mix is derived from the IEA NZE scenario and is still an ambitious ask. However, it is achievable because companies can decide for themselves how to get to this threshold: They can cut hydrocarbon production, invest in the low carbon solutions that are most suited to them, or a combination of both.

This criterion was developed over the course of the oil and gas program as we engaged with companies, other investors, and third-party experts. For engagement to be successful for the investor and meaningful to the investee company, it is critical that targets are grounded in pragmatism.

4. OBJECTIVES ARE RELEVANT TO LONG-TERM SHAREHOLDERS

Engagement objectives should be in the interest of long-term shareholders and sit at the convergence of financial and sustainability performance. There is less chance of success without this alignment, as most investors will oppose changes that will negatively impact returns. Disagreements will still occur, however, because time horizons often differ. The Dutch based pension fund, by nature a long-term investor, launched the oil and gas program because it holds the conviction that climate change represents an unmanaged risk for oil and gas companies in the long run. Other investors, and potentially company management, may have a short-term perspective and would prefer a slower transition away from fossil fuels.

5. OBJECTIVES AND MILESTONES ARE TIMEBOUND

Although it is standard for an engagement program to have a beginning and end, we advocate making intermediate milestones timebound, as well. As mentioned, milestones should be realistic and this should extend to when they should be completed. Each year of engagement should result in some sort of progress, with earlier years having less ambitious milestones, such as the public disclosure of sustainability-related policies. Later years build on these earlier steps and objectives can thus be more ambitious, including setting targets and increased investment in sustainable projects.

If a company does not achieve the milestones in the given expected timeframe, there should be escalation implications. In other words, if you are not achieving what you expect, all things equal, you should try something different. In the earlier years of engagement, this can entail less extreme measures, such as expanding the investor engagement coalition. As more time goes by without achievement, more severe forms of escalation should be explored to dial up the pressure on companies, such as filing shareholder resolutions or making public statements. Divestment, as a targeted escalation tool, can still fit within the SMART engagement approach. Although generally not having a direct impact on a divested company, it frees up resources for an investor to invest in and engage other investee companies. Divestment is thus used as a last resort when, after intensive engagement, investee companies prove unwilling to change, and it should take into account the potential impact on return.

> FOR ASPIRING 3-D INVESTORS THE ENGAGEMENT ROUTE CAN STILL BE CONSIDERED, HOWEVER IT SHOULD BE SPECIFIC, MEASURABLE, ACHIEVABLE, RELEVANT, AND TIMEBOUND (I.E., SMART)

For the oil and gas program, the first milestone was a baseline one, which companies were expected to already have completed, the second was to be achieved at the end of the first year, and the overall objective by the end of the second year (2023). If they did not comply at each stage, they were divested from the portfolio. We consider this an accelerated version of SMART engagement, underpinned by a sense of urgency to act on the oil and gas sector. SMART engagement programs should typically last between 3-5 years to give ample time for companies to change and include a range of escalation options.

BENEFITS OF THIS APPROACH

We believe that an engagement approach that is SMART can have the following two benefits:

DEMONSTRATE THAT YOU ARE PRIORITIZING IMPACT

Starting with SMART engagement means you are prioritizing your role as a potential agent of change by encouraging companies to change. Engagement does not always succeed but it stands a better chance of impact than divestment. Furthermore, engagement gives industry leaders a chance to emerge and can help show that certain activities should not be treated as black and white. Important lessons can be learned by intensively engaging companies and new perspectives gained (Marti et al, 2024).

In the oil and gas program, at end of the second and final year of engagement, just seven listed companies (2% of the total oil and gas portfolio at the start of 2022) had demonstrated that they were aligned with our criteria, which showed us that they are meaningfully contributing to the goal of the Paris Agreement.[2] It ultimately proved too great a challenge for most of the sector,

which was made more difficult because of the global energy crisis that began in 2022 and slow pace of customer transition. This included all the Oil and Gas Majors, the majority of whose investors supported a slower pull-back from their oil and gas activities. Those that remained in the portfolio were relatively smaller, more regionally focused oil and gas companies that could take advantage of specific niches, such as renewable power on the Iberian peninsula or sustainable aviation fuel in Europe.

THE SMART APPROACH WILL HELP SHOW THAT AN INVESTOR PRIORITIZES IMPACT AND IMPROVES THE LEGITIMACY OF THEIR ENGAGEMENT

Although only a few companies remained in the portfolio at the end of the program, they show that there is a roadmap for the sector to follow and a path to re-entering the portfolio. Developing realistic inclusion criteria and identifying these oil and gas sector leaders were only made possible by going through the SMART engagement process.

INCREASED LEGITIMACY

Setting clear milestones and making them timebound means that SMART engagement is undertaken with urgency. An engagement team is thus motivated to use all tactics to increase effectiveness, including collaborating with local peers, employing escalation, pushing for meetings with upper management. Stakeholders will see that you are trying all you can to get engagement to succeed.

Further increasing your legitimacy is the willingness to act on the non-achievement of milestones. Giving engagement a chance is important, but equally important is being honest to your stakeholders about what is working or not working and how to respond. If this ultimately leads to divestment, you can at least say that you stuck to your convictions. Furthermore, resources are now freed up to invest in more willing companies where a greater chance of impact may be achieved. At the conclusion of the oil and gas program, the engagement focus has expanded on companies operating in the utilities, materials, industrials, and food sectors, as these are the next major contributors to global emissions.

CONCLUSION

Ultimately, it is up to each investor to determine what approach works for them if they wish to pursue an impact-focused strategy. As an industry, we believe that we are at the start of figuring out how best to do this. We also believe that a more nuanced and pragmatic approach to non-sustainable companies works best and think that engagement has a central part to play in a 3-D investment strategy. Last but not least, we believe that if we play it SMART, by placing impact and legitimacy at its core, we can do our part in helping engagement reach its full potential.

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Notes

1 https://www.fsb-tcfd.org/

2 The program did not focus on the unlisted oil and gas portfolio because of liquidity constraints and differing engagement approaches. For example, investments oil and gas companies as a limited partner to a fund would require working with the general partner rather than company itself. A separate, more suitable program is being implemented for this space.