

ESG Materiality and Shareholder Engagement... *What's Next?*

Intentional
Endowments
Network

An initiative of
CraneSustainability.org

When it comes to proxy voting, large shareholders may soon find that playing absentee with their shareholder engagement duties is no longer an option. Today, widespread information has created engaged investors and consumers who want to know how companies they do business with, well, do business. Sitting on the sidelines may be very expensive.

Proactively managing risk factors can not only identify potential liabilities but also improve strategic and operational performance. As investors' concerns regarding corporate practices evolve, their willingness to file resolutions, engage with companies and use their proxy power as a means of creating change is on the rise.

With the kickoff of the 2018 proxy season, the **Intentional Endowments Network** (IEN) talked with industry specialists to gain insight on some of the key areas of concerns for investors and their process to discern financially material issues. The specialists included:



MATTHEW SHERWOOD

Director, Public Markets Investments at **Ministers and Missionaries Benefit Board**², \$2.6 billion AUM



MARY BETH GALLAGHER

Executive Director at **Tri-State Coalition for Responsible Investment** (CRI)³, collectively represents over \$2.5 billion in AUM



DOUG MORROW

Associate Director of Thematic Research at **Sustainalytics**⁴, a research and ratings provider focused on ESG and corporate governance

IEN: Over the next 12-18 months, what issues may be considered as financially material?

SHERWOOD: Understanding that we are most likely in the late stage of the cycle, financially material ESG issues may come in various issue-types as downside risk is more probable, and if certain issues are ignored, the securities of a company may decline at an accelerated pace in a market downturn. A few issues worth monitoring:

- Given the media's attention on **sexual harassment and gender discrimination**, across all sectors, but predominantly notable in technology, media, and telecommunications as of recent months, Gender Diversity and Sexism in the workplace are issues that could become financially material over the next two years. Companies that have been identified as having cultures of sexism and a hierarchy of male dominance may soon be under pressure by institutions divesting from equity or debt exposure, and experience consumers who may shy from spending on the company's products and services.

It would be of no surprise that if in the next couple of years the consumer/shareholder no longer solely engages with a company that has no women on their board through proxy voting, but does so through boycotting and anti-company social media campaigns. For this reason, gender diversity in a company's management and the corporate culture as it relates to sexism becomes a financially material issue.

- Although not a new issue, **fossil fuel divestment** may be a driver of financially material information. This is largely an issue of CapEx availability and oil prices. That said, the significant traction of the social movement has put pressure on more than 600 institutional investors representing \$4 trillion + in assets to commit to divest from fossil fuels over the next five years- which began in 2014, and will surely be a flow-of-funds force against the energy sector in the next two years. The governance structure and sustainability practices will be key to the future success of many Oil & Gas Exploration & Production companies.

GALLAGHER: The issue of **human rights** impacts in the global supply chain, where suppliers to US companies may be exploiting workers through forced or child labor,

and US companies may be benefiting or profiting from this exploitation. We recently launched a new investor engagement called *Shifting Gears*, by Amrita Sareen-Tak, which focuses on the automotive industry, where many commodities at risk of being produced with forced or child labor - from leather to mica to rubber to pig iron - come together into one end product that is ubiquitous in the United States, even fundamental to the American identity.

We have sent investor letters and plan to engage with 23 OEM and Tier 1 suppliers in the automotive industry to understand how effective their existing policies and practices are in managing human rights risks. Specifically, we are concerned because workers involved in mining, harvesting, and processing the different raw material inputs for cars are exposed to serious human rights and labor rights violations. We will encourage companies to disclose how they are managing these risks, so that investors might be able to identify leaders and laggards in this space and appropriately integrate this information into their investment process. All of this will also provide consumers – who are increasingly interested in knowing where and how their products are made –with more information on company performance as they consider purchases of this big ticket item.

MORROW:

- **Water Scarcity:** The demand for water is surging, and not enough investment is taking place to bring adequate new supply to market. The widening gap between demand and supply is exacerbating regional water scarcity, putting policy pressure on governments and causing production headaches for companies. Water plays a deceptively important role in many industries, including manufacturing, mining, textiles and chemicals. It also underpins global food and agricultural output. We expect to see immense water infrastructure investment over the mid-term, which will be a boon for infrastructure suppliers. We also anticipate an overhaul in the way that water is priced – current models do little to encourage efficiency or investment.
- **Supply chain management:** Customers increasingly want to know how their products are made, and where the components come from. The industry response has been to improve supply chain transparency through traceability programs, but they remain in the early stages. We expect considerable innovation in supply chain management over the mid-term, with

technological catalysts in big data, transport software and blockchain. The risk, and opportunity, is greatest for industries with complex, multilayered supply chains, including consumer electronics, automotive, aerospace and defense, and industrials.

- **Data privacy and security:** This is an issue that is already of central importance to management teams across a wide range of industries, but given the scale of the risk we expect a significant uptick in investor discussion, investment and company action in the near future. The nature of the challenge is that more and more of our lives are being measured and stored online in cloud-based systems. It is not just the omnipresent threat of data breaches, such as those that recently occurred at Uber, Equifax and Yahoo!, but complex and constantly changing data privacy laws. We ultimately see data privacy and security as an economy-wide issue but in the short run the most exposed industries are those that store large amounts of confidential information (such as banks, healthcare, insurance, media and telecoms) and those that are responsible for data management services (such as software and technology).

IEN: How do you determine what issues are financially material?

SHERWOOD: It is a heavily research-based matter. Much of the issues that might be financially material, may be more in line with an environmental or social movement, but do not have a financially material affect. Much of this research is fundamental and qualitative, but quantitatively, I analyze ESG factors as risk premia potential, which can often provide further insight on the potential impact of the issue.

GALLAGHER: Automotive OEMs and Tier 1 suppliers are exposed to human rights risks of using forced labor, child labor, and having poor working conditions in their value chain. We focus on the salience of these human rights

issues – looking at the impact of business on workers, communities, and society. Our process started with the business impact on communities and where there is interference with fundamental rights, rather than the cost to the investor; though we believe these two pieces are integrally connected because companies that have stronger governance and management of social risks are likely to be better managed and have a more resilient long-term strategy.

Investors are also seeking greater visibility into companies' supply chains to encourage more responsible sourcing practices. In order to guarantee that supply chains are slavery-free, companies must be able to map the locations of all the steps in their supply chain. In addition to expectations around disclosure, demand for some raw material inputs is growing, such as the use of cobalt in lithium-ion batteries as vehicle electrification increases, and the environmental benefits of these new technologies must be balanced against the severe human rights risks to workers and to companies. Cobalt is an example of a mineral that is not currently regulated under conflict minerals legislation, but still presents serious human rights risks.

MORROW: Our approach for determining which ESG issues are financially material is rooted in understanding the myriad ways that ESG issues can cause both positive and negative business impacts. ESG-driven business impacts have been borne out empirically: there is a growing body of evidence showing that companies with superior ESG performance benefit from superior resource and energy efficiency, the ability to attract and retain higher quality employees, more effective marketing of products and services and a reduced likelihood of incurring negative regulatory, legislative or fiscal penalties.

We strive to achieve a reasonable balance between looking at company policies and programs, and company involvement in on-the-ground incidents and controversies. Our collection system for the latter uses machine learning algorithms to monitor approximately 60,000 sources of information across the world.

¹ <http://www.intentionalendowments.org/>

² <https://www.mmbb.org/how-we-invest/>

³ <http://tricri.org/shareholder-engagement-proxy-voting-services/>

⁴ <https://www.sustainalytics.com/esg-research-ratings/>