

IEN Q&A: Investors Wield Shareholder Power to Address Climate Investment Risks

The urgency to address investment risks posed by climate change has increasingly prompted stakeholders into action. A popular strategy within the equity ESG toolkit is wielding shareholder power to evoke change. Collaborative efforts, such as the **Climate Action 100+** has allowed investors to have a stronger voice in corporate boardrooms. The Climate Action 100+ represents over 370 global investors with over \$35 billion in AUM, and is focused on ensuring that the world's largest greenhouse gas ("GHG") emitters take necessary action regarding environmental shifts.

The [Intentional Endowments Network](#) approached members of the Climate Action 100+ to better understand their approach to addressing climate investment risks by exercising their shareholder rights. Such investors included:

Samantha McCafferty, Assistant Vice President, Sustainable Investing, **Harvard Management Company ("HMC")**, \$40.9 billion in AUM



Daren Smith, President & Chief Investment Officer and **Lisa Becker**, Chief Operating Officer, **University of Toronto Asset Management Corporation**, \$8.5 billion in AUM



Paul Hilton, Partner/Portfolio Manager and **Brianna Murphy**, Vice President, Shareholder Advocacy, **Trillium**,* \$3.0 billion in AUM



Geeta Aiyer, President/Founder and **Lisa Hayles**, Principal, ESG Specialist, **Boston Common Asset Management****, \$2.7 billion in AUM

HEN: HOW DOES CLIMATE CHANGE IMPACT YOUR PORTFOLIO?

McCafferty: HMC, like all investors, must account for both the physical and transition risks related to climate change, across our portfolio. These can include changing climate patterns, rising sea levels, and property damage or supply chain disruption from extreme weather events, such as wildfires, droughts, floods, and more. Policies and commercial technologies that reduce fuel consumption and GHG emissions will also impact companies and industries that fail to embrace the underlying risk.

On the other hand, there are real opportunities for companies and investors who are better prepared to mitigate the risks of climate change and operate in a lower carbon economy. Because HMC invests primarily through external managers, we expect our managers to consider all relevant ESG factors—including those related to climate change—that could have a material impact on the financial performance of the assets they manage, and to have a willingness to engage with us in an ongoing dialogue on sustainability.

Smith/Becker: Climate risks are broad-based and are expected to have varying degrees of impact on our portfolios. We evaluate climate change-related risks using the framework developed by the Task Force on Climate-related Financial Disclosures (TCFD). Under the TCFD framework, climate-related risks fall into two major categories: (1) risks related to the transition to a lower-carbon economy and 2) risks related to the physical impacts of climate change.

We have developed a variety of tools to assess our exposure to various climate-related risks. As a first step, we analysed our exposure to the sectors and countries that we believe would be the most impacted by climate change. From there we built tools to examine how various transition scenarios could impact our portfolios. This included running a scenario analysis that looked at the impact of technological disruptions related to climate change and how that could help or hurt certain sectors. Recently, we expanded our analytical tool-kit to begin evaluating the impact of physical risks on our portfolios.

Hilton/Murphy: Climate change presents increasing risks for every company, including the public companies in our portfolios. While many of our companies offer direct climate solutions in terms of climate mitigation or adaptation, they are all increasingly aware of the growing number of challenges and risks of climate change, especially as it pertains to their businesses and industries. For example, there are destructive risks from extreme weather events, supply chain risks from changing climate patterns, health risks due to changing disease patterns, and pressures on the quantity and quality of water for drinking, agriculture, and industrial uses, just to name a few.

Along with these climate related challenges, there are numerous climate investment solutions opportunities such as desalinization and filtration of water, energy efficiencies, the growing supply chain for electric vehicles (EV's), renewable energy, resilient building products, regenerative agriculture, recycling and repurposing, among many others. One example would be **Ingersoll-Rand (IR)**, an industrial company leading the way in producing energy efficient HVAC systems for commercial, industrial, and residential applications. IR recently announced

the spin-off of its industrial pumps and compressor business to focus exclusively on its higher growth climate-control and solutions businesses.

Aiyer/Hayles: Markets typically mis-value the risks and opportunities presented by ESG factors, both in terms of the timing and the magnitude of outcomes. Climate risks affect all sectors and sub-sectors, some more directly than others. We use a combination of ESG integration and proactive shareowner engagement to address this challenge.

- **Concerns regarding stranded assets** have much broader implications than the 200 hydrocarbon producers targeted by activists. We extrapolate further to include industries that will be deeply affected by climate change but perhaps not cut to the core, for example: transport and shipping, energy-intensive chemicals and fertilizers, livestock and agricultural companies.
- **Changed economics of the business** due to changes in costs, market demand, pricing power: These changes could come from regulatory changes, weather related disruptions, changes in consumer preference, social license to operate, etc.
- **Carbon risks in sectors that are not traditionally carbon intensive:** Examples can be found across the board, including in sectors such as Financials and Consumer Staples. Increasing lending to carbon-intensive segments or businesses create the potential for correlated non-performing assets and mis-priced loans.
- **Seeking Opportunity everywhere:** We look for providers of and leaders in energy and water efficiency, financial and technological solutions throughout the economy's value chain, which will benefit competitively from the transition to a low-carbon economy.

IEN: WHY DO YOU THINK SHAREHOLDER ENGAGEMENT IS A PRUDENT TOOL TO TACKLE CLIMATE CHANGE? ARE THERE OTHER STRATEGIES YOU EMPLOY TO TACKLE THIS RISK?

McCafferty: Shareholder engagement allows investors to tackle specific issues that could pose material financial risks to their portfolios. Investors can utilize a wide range of engagement approaches from letter writing campaigns and in-person meetings with executives and board members, to supporting shareholder resolutions that address climate-related risks and voting for removal of leaders who have not demonstrated accountability. There is no one size fits all solution to tackling climate change in investment portfolios, but shareholder engagement is useful to address specific climate-related risks and to ensure that companies are sufficiently responsive to those risks.

We have also found corporate engagement through collaborative efforts to be a productive means for addressing climate-related risks. Over the past few years these efforts have effected significant positive change in their operations and their approach to GHG emissions.

Smith/Becker: Active ownership, specifically exercising our right to vote and engagement with issuers on material ESG matters, is foundational to our responsible investing beliefs, regardless of the particular ESG issue. As a relatively small institutional investor, we don't tend to engage with companies on our own. Instead, we typically participate in shareholder engagements through collaborative initiatives and through an engagement service provider.

We participate in a number of collaborative initiatives, one of which, Climate Action 100+ has already generated a number of successes from among the targeted companies. With respect to our engagement service provider, one of their key engagement themes is climate change. We find that our engagement service provider brings structure, discipline, expertise and tools to the process of shareholder engagement. Importantly, this service allows us to pool our assets for engagement purposes with other like-minded investors and achieve more influence than we could achieve on our own.

In addition to engagements, there are other initiatives that can be effective particularly related to climate disclosure practices such as **CDP** (formally the Climate Disclosure Project), which along with its Forests and Water disclosure, encourages disclosers to measure and manage their environmental impact.

Hilton/Murphy: We believe shareholder engagement is a crucial tool in pushing companies to address climate change risk, as well as to focus on emerging opportunities. Trillium files roughly three dozen shareholder proposals a year on a variety of ESG issues, with many specifically focused on climate change. This may mean pushing companies to report GHG emissions, set concrete GHG emissions reductions targets, make commitment to generating or purchasing renewable energy, or developing policies to tackle food waste, a major contributor to methane emissions. We also evaluate how companies are responding to climate change threats with their policies and goals, relative to other peers in their industry. We expect companies to have a thoughtful and clearly articulated climate change strategy that positions them to succeed in a quickly changing regulatory, physical, and consumer environment.

Aiyer/Hayles: Shareholder engagement is imperative in the area of climate change as it represents a systemic risk, that cannot be divested or diversified away. In broader terms, our proxy voting and engagement is intended to support long-term thinking by corporate managements. Long-term oriented decision making will improve the fundamentals of the companies we invest in, eventually becoming reflected in the value of its shares. These improvements may take the form of lower risk premia, higher earnings, cost savings, product and process innovation, or policy changes. We seek transparency and accountability from companies, but also empower steps for each towards a better ESG framework. Our most common approach is sustained dialogue with companies over the short, medium, and long-term, either through company or industry level engagement.

Q: CAN YOU SHARE YOUR PROCESS REGARDING ENGAGEMENT? HOW DO YOU DETERMINE WHICH FIRMS TO ENGAGE WITH AND HOW DO YOU THEN GO ABOUT IT? DO YOU HAVE SELF-IMPOSE TIME LIMITS REGARDING ENGAGEMENT?

McCafferty: We mainly participate in collaborative engagements through our strategic partnerships with the Ceres Investor Network and the **UN-supported Principles for Responsible Investment** (PRI). Over the past five years, HMC has participated in a number of efforts including transparency in corporate climate lobbying, methane emissions management and reduction, and more.

We generally do not impose definitive time limits on our engagement efforts. The strategy and timeline for each engagement is unique and often determined in coordination with other participating investors. For these efforts to be successful they take time, patience, and often multiple conversations. As long as we view the conversation as productive, we will continue to engage with the company.

Smith/Becker: With respect to service provider led engagements, we provide input annually regarding themes and issues that are of priority to us. This proactive exercise of setting priorities naturally leads to target companies that may be the most challenged with respect to their practices related to these themes. Events and controversies arising during the year will add companies to this list of engagements on a reactive basis.

When we participate in collaborative engagements, we tend to focus our efforts on those companies that are most relevant to our client's portfolios and, secondarily, are domiciled or active in our domestic market, i.e., Canada. Setting objectives with respect to each engagement is important but we don't impose a time limit. In many cases, engagements take place over the course of several years and the topics discussed change over time.

Hilton/Murphy: We have a number of tools available to us as we pursue engagement, which is conducted by an in-house team of dedicated professionals. This includes meeting with companies, letter-writing, proxy voting, and filing shareholder proposals. Our analysts and portfolio managers participate in company dialogues to make the financial case about the importance of changing policies. Generally, we identify leading companies in a sector that may have one area of the business that still represents a significant risk, such as a weak commitment to tackling carbon emissions. We first have a discussion with the company and if we do not make progress, then file a shareholder proposal to press for improvement. These proposals often get greater than 30% votes. Often companies will agree to our recommendation before the proposal goes to a vote. There are no set time limits regarding engagement. Our engagement with **Apple** has spanned over 12 years on a variety of issues including board diversity, human rights, privacy, toxic chemicals, and climate change.

Aiyer/Hayles: In order to prioritize our focus and impact we have established a three-year engagement framework with two to three key initiatives across our three ESG sustainability pillars. We review these initiatives on an annual basis and track engagement impact through our reporting. In addition, we are focused on aligning our investments and our engagement activity with the **United Nations' Sustainable Development Goals** and its post 2030 sustainable development agenda. Finally, we tackle emerging issues such as gun violence, private prison labor and immigration detention.

As many our engagements are linked to transforming practices across industry sectors and raising standards, we do not have a time limit for participation in a broad initiative. However, we do review our strategies annually against our three-year plan and will revise the focus on our initiatives and the 'stretch targets' for each depending on the progress we have achieved during the current plan.

IEN: CAN YOU SHARE CHALLENGES TO THE ENGAGEMENT PROCESS? IS THERE ANY ADVICE YOU CAN GIVE TO INVESTORS CONSIDERING ENGAGEMENT VERSUS DIVESTMENT?

McCafferty: When HMC moved to the generalist investment model in 2017, relying more heavily on external asset managers, we had to adapt our sustainable investing program. This included how we think about ESG integration and engagement. Participating in collaborative engagements with other investors was one obvious way to continue to drive progress. We have found that collaborative engagements help provide a consistent message to companies, especially around requests for additional disclosure. With investors on the same page, it is easier for companies to understand which standards or issues they should be focused on.

To be clear, decisions on divestment rest with the University and not HMC, but the issue of climate change is far too urgent for us to simply disengage with the industries whose practices we hope to change. Investors—either current or prospective—are best positioned to influence a company's decision making on climate-related risks and opportunities through engagement.

Smith/Becker: As a small team, it is not possible to undertake a significant number of engagements ourselves. Additionally, we believe that teaming up with other like-minded investors is a more effective approach.

Investors who divest lose their "seat at the table" and in our opinion are much less likely to be successful in effecting meaningful change at a given company. We strongly believe that engagement is a much more effective approach than divestment. Having participated in many engagements, one recurring theme that has been expressed to us by management teams and boards, is that the opportunity to hear the concerns of investors firsthand and directly has impacted the way that they look at issues and has caused them to re-evaluate their approach. This wouldn't happen with a divestment approach.

Hilton/Murphy: Many companies actively fight our shareholder proposals, making the case that we are interfering with ordinary business or being too prescriptive in our recommendations. Companies can make their case directly to the SEC which can choose to scrub (or “omit”) our proposal. Each year we work diligently to frame our proposals using the right language to 1) make a compelling business case to the company, 2) make it through the SEC review process, 3) demonstrate to a coalition of investors the validity of our call to action. Our long history in the field of advocacy helps give us the skills and brand to push forward change. While some companies can be changed, many cannot. We recommend focusing resources on companies willing to see the bigger picture and with management teams who are stakeholder centric.

Aiyer/Hayles: Investors often frame the discussion as either divestment or engagement, but the discussion is quickly evolving beyond characterizing the challenge of addressing climate change in an either/or choice for investors. Investors will need to selectively avoid the most carbon intensive companies/industries and engage with companies across portfolios regarding issues such as:

- reducing energy use;
- climate lobbying that undermines the Paris Agreement; and
- supporting a just transition to a low(er) carbon economy to ensure that the costs of the transition are not borne disproportionately by the vulnerable.

For a college endowment or foundation, the most important first step is articulating and setting out the framework for incorporating ESG issues and an approach to active ownership in an Investment Policy Statement or relevant organizational policy document. The next step would be to research their investment adviser/consultant or investment managers’ expertise on ESG integration and active ownership strategies. College endowments or foundations should be encouraged to join collaborative initiatives and to look into how their investment manager(s) are voting their proxies.

IEN: HOW DO YOU MEASURE SUCCESS? CAN YOU SHARE ANY ANECDOTES/EXAMPLES OF SUCCESS STORIES?

McCafferty: At the start of each engagement we establish clearly defined goals and an anticipated timeline against which we can track our progress. For example, in 2017 we co-led a PRI-coordinated engagement on methane emissions. The objectives were to (1) encourage energy and utility companies to reduce their methane emissions and (2) to disclose their progress. During the course of the engagement, several major energy companies announced plans to set voluntary methane reduction targets. Seeing these outcomes reinforces the power of investor engagement.

Smith/Becker: We regularly set objectives on our engagement efforts and track progress against those objectives. Through our engagement service provider and through our collaborative engagements we have been a part of many successful outcomes, which we

define as meaningful, measurable change in a given area. As part of our overall Responsible Investing framework, we publish an annual [Responsible Investing Report](#), which includes case studies of successful engagement outcomes. In last year's report, we highlighted an engagement with the consumer staples company, **Mondelez International Inc.** that resulted in the company committing to make all packaging recyclable by 2025 and sustainably sourcing all paper-based packaging by 2020.

Hilton/Murphy: Success means creating an impact with our advocacy work. This could be a negotiated withdrawal that also leads to an immediate policy change or a high shareholder vote in favor of one of our proposals that ultimately leads to a policy change. For example, we withdrew our proposal at oil & gas exploration and production company **EOG Resources** after they made a commitment to set both qualitative and quantitative methane emissions reduction targets in 2019 and 2020. A proposal at food products company **Smuckers** on Renewable Energy received a 27.5% vote from shareholders in 2018, but led the company to adopt its first renewable energy purchase commitment later that year.

Aiyer/Hayles: We measure and track our impacts on an annual basis and publish an annual '[Impact Report](#).' We also report quarterly in our '[Active Investor](#)' newsletter on current activity in the quarter and milestones we have achieved. In 2018 we identified 43 concrete impacts which fell into 3 categories:

- **Changes in products - Standard Chartered Bank** adopted new guidance on lending to the power generation industry given our engagement regarding the financing climate change
- **Changes in process** - new targets for emissions reduction: **Home Depot** agreed in December 2018 to new science based GHG reduction targets after consider of a shareholder proposal.
- **Changes in Policy** - Ethical Recruitment: We used the 'Know the Chain' public benchmark to identify laggards on supply chain oversight. **PepsiCo** scored a zero. As a result of our engagement - the company adopted a prohibition on worker-paid recruitment fees.

**This is not a recommendation to buy or sell any of the securities mentioned. It should not be assumed that investments in such securities have been or will be profitable. The specific securities were selected on an objective basis and do not represent all of the securities purchased, sold or recommended for Trillium's advisory clients.*

*** Information presented in this article should not be considered a recommendation to buy or sell any security.*