ENHANCING STEWARDSHIP ENGAGEMENT THROUGH YOUR ASSET MANAGERS:

EXAMPLES OF TACTICS AND QUESTIONS THAT TRUSTEES CAN USE

INTRODUCTION

The purpose of this document is to illustrate tried-and-tested tactics that schemes can use to enhance the impact of their stewardship through their asset manager engagement. It is intended to complement current approaches that you may use as well as looking specifically at what trustees may wish to do. While it has been written for engagement with managers, many of the examples can be easily transferred to engagement with other service providers, including investment consultants.

Terminology:

- ‘Trustee’ refers to members of the Board of Trustees, including the chair of the Board
- ‘Scheme’ refers to a pension scheme/fund
- ‘Manager’ refers to an asset manager/fund manager

Recruiting

Asset owners need to ask many specific questions to assess how a prospective manager considers sustainability-related factors in their investment decision making and stewardship activities. Ensuring that these questions lead to a response that will enable the 'so what' to be answered is key. For example:

- Asking a prospective manager if they have a target related to climate, nature or social impact does not provide detail on how they assess how sustainability-related systemic risks may affect the investments they make, or how these investments may deepen or lessen these risks. The question 'How are sustainability-related factors at both an entity and portfolio level evaluated, and what scenario analysis approaches do you follow?' would elicit a more informative response than, for example, a net zero target question.
- Asking a prospective manager how they embed sustainability into their engagement practices should include questions such as:
  - 'What systems do you have in place to capture engagement objectives systematically and to measure progress against sustainability objectives?'
  - 'What is the oversight process to ensure engagement objectives are robust, material and consistently adopted across the organization?'
- Asking a prospective manager how they integrate sustainability considerations into investment decisions and where specific sustainability-related decisions are made in the firm will help to provide a picture of their capacity and motivation. Also, asking them to explain decision-making processes that, for example, led them to continue to hold lowest-ranking (according to eg the Transition Pathway Initiative) companies will move the discussion away from being too high-level.
- Asking about the biggest challenges managers would face in aligning your portfolio with the goals of the Paris Agreement would lead to a discussion on their ability to understand the long-term systemic risks of climate change.
- Asking them what they have identified as their most significant nature-related risks and how they manage and mitigate these risks (especially in areas with limited or poor data) will give you a better understanding of their approach.
- Asking which initiatives they are actively involved in (eg Transition Pathway Initiative (TPI), the Institutional Investors Group on Climate Change (IIGCC) working groups, Climate Action 100+ and NatureAction100) will give you an idea of their appetite to work with you on system-level engagements both across the ecosystem and with investee companies. It will also give you an idea of how they coordinate their engagement efforts within these groups.
- Asking where stewardship activities such as engagement and voting are outsourced, how the stewardship provider determines when an engagement has been unsuccessful, and what escalation steps they take in those cases (eg initiating a new engagement cycle, voting against management, or recommending divestment) will help you to understand their level of engagement with and the accountability of holding companies.

Ask your team to review the Bulk Annuity Sustainability Survey, used by the bulk annuity market for pensions to assess the sustainability credentials of bulk annuity insurers. This will allow you to see if any questions would work for your recruitment process and associated survey/questionnaire sent as part of this process.

Recruiting
Ask prospective managers their view on specific trustee internal positions (such as on the role of the energy sector in addressing long-term risk to the scheme), eg ‘How do you think the energy sector might evolve and what factors do you consider to inform your opinion?’ This approach has proven effective in prompting deeper reflection and supporting reallocation away from high-emitting companies with weak long-term prospects.
Ask prospective managers to bring responses to life with real-time (anonymous, if necessary) examples.
Explain why an asset manager (or indeed an investment consultant) did not win the mandate. This information should be sent straight to those at the top level of the organization.

Monitoring

Setting an annual expectation: Send a formal letter from the chair, CEO or CIO of the scheme to all your managers outlining your stewardship and sustainability priorities. Expectations should be tailored to the scheme's governance model, as stewardship may be carried out by the same investment manager, by a separate provider or in-house.

This could include:

- The scheme's sustainability intent – whether the focus is performance, real-world impact or portfolio improvement over time
- Expectations that managers need to align to these priorities and, ultimately, long-term stewardship outcomes, and that sustainability and traditional investment performance will be reported on together; this alignment should apply both at the mandate level and, where relevant, to the manager's firm-wide stewardship and sustainability practices
- Trustee internal positions on high-priority sectors and expectations that managers will assess the alignment of their existing mandate to this position, eg what would need to change across current holdings (divestment, scaled-up engagement/escalation plan) and why?
- Specific objectives across the stewardship and sustainability priorities against which managers can measure progress throughout the year, eg decarbonization, nature-positive investments
- Setting out expectations for the manager and the scheme to have regular, multiyear engagement on defined topics addressing climate change, nature or social impact, including human rights and just transition issues

Turn monitoring into a continuity exercise: Track progress against simple KPIs aligned with the scheme's expectations of your asset manager throughout the year, eg water use (including in areas of high water stress), or even simpler, the top five actions the manager will undertake on the scheme's behalf. Then use the data collected to inform the discussion at the annual or biannual monitoring meeting.

Ensure a feedback loop with the real economy: Where the manager has decided not to invest in a firm due to misalignment with your investment beliefs on sustainability (outside of any exclusionary screening), ask them to feed this back to the firm, making it clear to them that the decision was made on sustainability-related grounds.

Monitoring

Structure interactive monitoring meetings: Change the annual or biannual reporting meeting with managers from a presentation-style reporting session to one that is more conducive to deep discussion. Some top tips include:

- Inform the manager in advance of specific questions you want to ask, so that their investment team can prepare a meaningful response, which can then enable a quality and insightful discussion.
- If a manager talks in general terms about embedding sustainability into their processes, follow this up with 'How?' Managers may default to generic responses; trustees have found that posing one or two highly specific, challenging questions helps to break this pattern and leads to more substantive discussions.
- Ask managers to present on the selection and engagement process for non-current portfolios.
- Choose a company, companies or sector within your portfolio and ask your manager to report on engagement over a longer period (eg a year), including how the responses from the company/companies are fed into your manager's investment assessment of the company/companies. Asking 'What would lead you to reconsider your allocation to this issuer?' could provide more clarity on how engagement outcomes are influencing buy, hold or sell decisions.
- Ask them for real-life examples of how they apply your investment beliefs and deliver on associated objectives when responding to questions such as:
  - 'Where have you divested or chosen not to buy?'
  - 'How are your holdings in X and Y consistent with your approach to stewardship and long-term investment, considering the clear risks associated with these businesses?'
  - 'Regarding the selling out of company X over the period, can you outline the engagement experience with the company's management over the last two years? How did the engagement fall short of your expectations?'

Use fourth-party data to complement your understanding of the portfolio analysis your manager has presented.

Expect stewardship to be used as a strategic tool: In addition to monitoring meetings, ensure your team gets regular insight into the impact of your manager's engagements with companies. This could include both reporting and issue-specific meetings, to understand:

- The processes, KPIs and tools managers use to hold companies to account for the stewardship expectations they have of them, and how this then informs the subsequent investment decision. How is progress against objectives assessed? How does the manager gain confidence that material change has been delivered?
- Interactions with specific investee companies, forward-looking engagement plans and escalation steps being taken where relevant.
- How the manager's engagement strategy across your portfolio is aligned to your scheme's long-term vision and stewardship outcomes.
- How escalation plans vary between different asset classes, portfolios or geographies, and whether these differences are appropriate.
- What form of engagement has had the greatest focus in the last period and has required the majority of the manager's engagement resources, and why. How the manager is measuring the effectiveness of this use of resources (recognizing that this will be measured over a longer period than the typical quarterly monitoring period).
- How the manager is engaging with peers who hold the same company, eg coordinating a multiple manager engagement approach with the investee company.

Monitoring

Focus on outcome-based progress: While quantitative metrics are easier to obtain from managers, these metrics alone rarely reflect tangible, real-world outcomes. An excessive focus on needing 'input' metrics (eg number of engagements) from managers can incentivize counterproductive behaviour. Trustees should seek to balance quantitative data demands with a report on outcome-based progress, eg the percentage companies in the portfolio that are actively transitioning and how this compares to market average. Some jurisdictions use 'improvement' as an outcome metric, eg companies improving their sustainability activities.

Insist on a systems-led approach to investment decisions: Managers should be able to demonstrate how they consider the interaction between climate change, nature loss and other sustainability-related systemic risks, and other macro drivers such as geopolitics, technological disruption and financial market dynamics. These macro drivers can significantly impact climate and nature-related risks, and vice versa. Questions to frame this discussion could include:

- 'What methods are you using to address the current shortfalls in climate scenario analysis (using long-term, linear, climate scenario models) that simplify assumptions and ignore complex factors such as tipping points?'
- 'What process do you use to estimate expected returns to 2050?'
- 'What is your response to the academic and institutional research into current approaches to adequately capturing the systemic risk of climate change and nature loss?'[1]
- 'Which leading and lagging indicators do you use to assess sustainability risks and financial risks, and how do you expect these indicators to interact over time?'

Use the 'rule of thirds' as an interim strategy to move managers away from a short-term focus. For meetings about specific challenges, areas or updates, agree to spend approximately one-third of the meeting deliberating on short-term aspects of the problem, one-third on medium-term aspects and one-third on long-term aspects.

1. You could cite some of these papers: University of Exeter and USS (2023), No Time to Lose; Institute and Faculty of Actuaries, University of Exeter (2023), The Emperor's New Climate Scenarios and (2024), Climate Scorpion: The Sting Is in the Tail.

Voting

Less is more: Rather than sending a questionnaire to asset managers about their proxy voting activity, which they may perceive as the task itself and treat as a tick-box exercise, focus your engagement with them on voting by:

- Asking one or two focused questions, eg 'What votes have you made against the re-election of directors [in X sector] on climate or nature-related grounds?' It is important to follow up such a question with a discussion on the manager's selection process and subsequent engagement activities with these companies.
- Selecting specific companies in your portfolio (eg using the TPI) to identify potential laggards and asking for the rationale behind your manager's voting decision, as this company-specific justification is especially important for holdings where independent benchmarks highlight weak sustainability performance.
- Following up the questionnaire responses with a face-to-face discussion to enable your asset manager to provide more clarity on the responses.

Close the feedback loop: Request that managers feed voting decisions and rationale back to the associated companies, and document this discussion, so that future potential progress can be observed.

Ensure your fund manager, and not just the governance lead, is in the room to report back on how their voting activity has aligned with your voting mandate, so that they can provide the rationale behind the decisions.

Use voting record analysis to inform discussions on voting strategy: Analysis of your manager's voting records (whether by yourself, through an adviser or using custom benchmarking platforms, eg Rezonanz) should include: (1) voting with/against company management; (2) voting with/against the manager's voting policy; and (3) contrarian votes, where the manager has voted in support of company management on a particular resolution where significant numbers of shareholders did not do so.

Contrarian vote analysis is often good for prompting a discussion on the long-term strategy of a manager's voting, moving away from a quantitative analysis, eg:

- 'Our analysis on your voting records shows that you have a greater tendency than others to vote in alignment with company management. Is this intentional?'
- 'How have you designed your voting policy, given that it has resulted in what appears to be leniency towards companies' management?'

These discussions are more effective when trustees bring one or two specific voting examples to work through in detail, as this helps avoid overly theoretical responses.

Take proxy voting in-house: Some schemes feel they have more control over their stewardship approach if they take voting in-house, being able to apply a consistent responsible investment policy across mandates/the portfolio and making it easier to escalate if they have engagement concerns. They would balance this move to in-house with limited resources, eg issuing a quarterly restricted list to managers and engaging directly with some investee companies as well as their managers.

Other considerations

Governance structure: Some schemes have introduced co-leadership roles to ensure that sustainability priorities and long-term investment considerations are embedded across decision-making processes and that responsible investment is part of every manager conversation – eg a co-chief investment officer and a co-chief responsible investment officer who share responsibility for the investment strategy.

Governance models differ across pension funds and insurers, eg in terms of where fiduciary duties sit or the extent to which investment and stewardship activities are outsourced. These differences shape how stewardship responsibilities are allocated, making it important for schemes to be clear about is accountable for sustainability outcomes within their own structure.

Separating the engagement and voting mandates from fund manager mandates: Some schemes opt to use an engagement and voting overlay – a single external provider for engagement and voting – in order to ensure consistency. While this, and the associated mandate, sits separately from the scheme's fund manager's mandate, it is essential that schemes still prioritize direct engagement with these fund managers to hold them to account.

Leveraging fund managers' resource and expertise to maximize direct company or sector engagement: Some schemes that have identified specific themes and challenges they want to address coordinate a joined-up approach with their asset managers. For example, the Church of England Pensions Board brought their managers together in engaging the global mining sector, creating the Mining 2030 initiative. Brunel Pension Partnership worked with one of its asset managers, Baillie Gifford, to analyse and integrate nature-related risks into their investment analysis.

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