The power of engagement and voting – acting as a universal owner

Environment Agency Pension Fund

10 YEARS of responsible investment

Martin Parsons, Environment Agency Pension Fund, interviews Colin Melvin, CEO of Hermes EOS, on universal ownership and stewardship.

Martin Parsons, EAPF

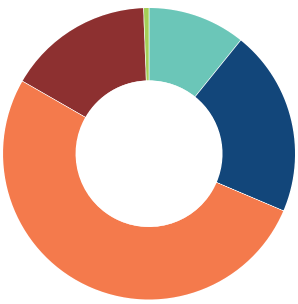
I joined the Environment Agency Pension Fund from Fleet Operations, which won Best Public Sector Fleet 2013 at the Energy Saving Trust's Fleet Hero Awards 2013, in September 2014, having been at the Environment Agency for 14 years. My role includes supporting the fund's work in responsible investment, in particular co-ordinating the engagement and voting activity in companies. As part of the 10 chapters celebrating 10 years of the EAPF as a responsible investor, I want to share this area of my work, demonstrating its importance to the fund and the interests of our fund members. Hermes EOS is an important partner in delivering this work for the EAPF.

Colin Melvin, Hermes EOS

Hermes EOS is one of the world's leading stewardship services.[1] As of 30 June 2015, it had £115.7 billion of assets under advice on behalf of over 40 clients, including the Environment Agency Pension Fund (EAPF). During 2014, Hermes EOS engaged with 379 companies on behalf of the EAPF, across a range of 1,054 environmental, social, governance, strategy and risk issues. In the same period, Hermes EOS also made voting recommendations for 3,192 meetings on behalf of the EAPF, covering 37,756 resolutions, in accordance with the EAPF's voting policy. Colin Melvin is chief executive of Hermes EOS and chaired the committee that drew up the original UN-backed Principles for Responsible Investment.

Global

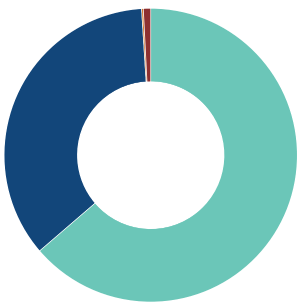
We engaged with 379 companies over the last year.



- Environmental 10.8%
- Social and ethical 20.6%
- Governance 51.9%
- Strategy and risk 16.1%
- Stewardship 0.6%

Global

We voted at 37,756 meetings (3,192 resolutions) over the last year.



- Total meetings voted in favour 63.7%
- Meetings where voted against (or voted against AND abstained) 35.3%
- Meetings where abstained 0.2%
- Meetings where voted with management by exception 0.8%

[1] It is part of UK-based Hermes Investment Management which is owned by the BT pension Scheme.

Martin: I know that my pension fund owns shares in companies as part of its investments but what does that mean in practice?

Colin: Owning shares in companies makes you eligible to vote at their annual and extraordinary general meetings and responsible asset owners take up that opportunity. It gives them a voice to show their support for or dissatisfaction with the company's performance, management and other issues they are concerned about.

We make voting recommendations on behalf of our clients, including EAPF. Voting at company general meetings is a shareholder's right and can be considered the bedrock of stewardship.

(Being a good steward is part of EAPF's approach to responsible investment discussed in the first chapter of this series).

Martin: I remember hearing in the aftermath of the global financial crisis, owners of companies, particularly pension funds (as 'asset owners') were accused of 'being asleep at the wheel'. What did that mean and was my pension fund 'asleep'?

Colin: To take the last point first, no your fund was not 'asleep'. The EAPF has been active as a responsible investor for over a decade and we have been delighted to support the EAPF in engaging with companies across all sectors and markets over that time.

The accusation of being 'asleep' was directed at those in the investment industry, including some funds, who could have taken more interest in their rights and responsibilities as shareholders in financial services companies, speaking with them about their risk management and conduct as well as the oversight their boards provided. This failure in stewardship contributed to the global financial crisis.

The good news is that since the financial crisis an increasing number of pension funds have been actively engaging with companies to avoid a repeat of the crisis and to mitigate any emerging risks to companies, such as bribery and corruption and climate change.

Martin: I have heard the terms 'universal ownership' and 'stewardship' in terms of owning companies – what do they mean?

Colin: "Universal ownership" means that as large long-term shareholders investing in lots of companies, pension funds have an interest in the success of economies and the ways in which companies interact with each other, society and the environment.

So, for example, a universal owner should be concerned when environmental pollution by one company affects other companies and their stakeholders. Universal ownership is also based on the belief that all the assets owned by pension funds ultimately belong to their members and therefore wider society. Asset owners and managers merely act on behalf of the beneficiaries. In practice, this means that we have to take a longer-term view and live and invest responsibly on a planet with finite resources.

Asset owners should be supervisors – in other words stewards – of companies and prompt them to act in the long-term interest of everyone. As stewards, we engage with companies on environmental, social, governance and strategic risks that are material to them. This is "stewardship."

Martin: We invest in thousands of companies, how do you select the companies you engage with?

Colin: We engage with companies where there is the greatest potential for positive impact. This means we address the difficult issues, which are most significant for the company, prioritising those where our engagement adds most value for clients.

So there is usually an issue affecting the performance or reputation of a company, which is material in the context of its business and important to our clients, such as EAPF. Sometimes the companies we engage with have made headlines for various controversies but more frequently any issues are not widely known. We often work collaboratively on our clients' behalf with other likeminded asset owners and managers to seek change at companies – the bigger the voice, the more influence we have.

Martin: How do you go about engaging with companies?

Colin: While we may be robust in our dealings with companies, the aim is to deliver value and change for EAPF and our other clients, not to seek headlines through campaigns. We are honest and open with companies about the nature of our discussions. We aim to keep the detail between the company and EOS, particularly in the early stages, as this is the best way to bring about change. We build relationships with the most senior executives and independent directors at the company, in order to increase the likelihood of a successful engagement.

Martin: What are the challenges in engaging with companies?

Colin: The challenge, particularly in some markets, can be making contact with the company at the right level – those who are in a position to instigate change. It is essential that we establish a relationship, without being mistaken for a single-issue pressure group that has short-term interests and/or an investor with narrow, potentially self serving interests. Getting companies to recognise that they have a problem can be difficult with some objectives, particularly when they relate to environmental or social risk management. Measuring success in our engagements can also be challenging as stewardship is not always easily quantifiable. To that extent, we have devised our own four-step milestone system that indicates the progress a company makes in relation to a particular engagement objective.

Martin: What does engagement success mean for me as a beneficiary, member of the pension fund?

Colin: A pension fund has a legal duty to invest in the best interests of its members, called its 'fiduciary duty' (see chapter one in this series). A number of factors influence the types of investments that need to be made. Engagement success means that the companies in which you invest through the EAPF are better run, more accountable and more sustainable. As a result, they should make better long-term investments and contribute to the long-term financial performance of the fund.

Martin: Does a vote against management proposals make a difference even if it is in the minority?

Colin: Yes it does, even if a vote against is in the minority, because it can support an engagement. Often shareholder votes are advisory in nature, in that the company is not legally obliged to react to them. In practice though, a large enough vote against on a certain issue provides momentum for change at a company. In total EOS made voting recommendations on around 10,000 meetings last year.

Martin: What weight of impact on the company does voting and engagement have, say compared to legislation, customer action and political pressure?

Colin: Companies are increasingly open to engagement by their shareholders and respond with significant and sustainable change. This is particularly evident in engagement relating to companies' behaviour, rather than their products. In contrast, change imposed through regulation can be more reactive and superficial. Furthermore, legislation tends to be based on the lowest common denominator, requiring the minimum from companies via a tick-box style approach. Customer pressure is also effective in bringing about change and can be an important catalyst alongside shareholder engagement.

Martin: What have been the hot topics for you when engaging with companies and voting at AGMs in 2015?

Colin: An increasing number of shareholder proposals to be voted on at companies' annual general meetings were filed on climate change, particularly at energy companies. With a global deal on climate expected at the UN Climate Change Conference in Paris in December 2015, naturally this has been a focus of our engagement agenda.

Good governance in companies, including independent directors, a separation of the roles of chair and CEO, pay that is aligned with the interests of shareholders and diversity including the right gender balance on the board – also remains core to our engagement programme and contravention to best practice in these areas is often a reason for us to recommend a vote against.

In addition, we have engaged on sustainable water management, health and safety management and labour rights, corruption and bribery, supply chain management, cyber security, sustainable palm oil, cultural change and sustainability reporting.

Thank you Colin for a very enlightening interview and the work Hermes EOS does for the EAPF. We see effective engagement and voting as a key tool in achieving sustainable long term performance for the fund. The voting and engagement undertaken on behalf by Hermes EOS and others can be viewed on the EAPF website – www.eapf.org.uk

Hermes EOS case study: Exxon Mobil – engaging for change

Colin Melvin: Oil and gas companies will continue to play a significant role in energy production for decades to come despite the welcome growth in renewables. However, we are pressing companies to move away from heavily polluting fossil fuels such as coal to those that emit less carbon such as gas, particularly in view of tougher climate change regulation. The EAPF strategy to reduce climate risk in the fund has resulted in reducing its exposure to fossil fuel companies. However, the EAPF recognises the importance of engaging with companies that produce and use fossil fuels if carbon emissions are to be reduced over the long term.

We have a longstanding engagement with Exxon Mobil. As the largest publicly quoted oil company in the world, it is one of the largest greenhouse gas emitters globally. Moreover, the use of its products is responsible for substantially more greenhouse gas emissions than its own direct activities. It is therefore a very important actor in the battle against climate change.

> "We are pleased that the company has been so publicly open on its position on climate change and willing to discuss it in detail."

In the past few years on behalf of the EAPF we have encouraged the company to explain its climate change strategy more clearly and are pleased with the company's considerable efforts to address this. We co-signed the Institutional Investors Group on Climate Change carbon asset risk letter in 2013. The company wrote a public, detailed response to the letter which has moved forward the debate on what oil and gas companies should do in response to climate change. Alongside this written response, the company facilitated two lengthy meetings for interested investors, in which we participated, on the issue in 2013 and 2014. These have increased the mutual understanding of the company's and investors' ideas on climate change. We also had a one-to-one meeting at Exxon's headquarters on climate change at which we were able to explore some of the challenges the company faces at great depth. These interactions have been supplemented with other written and telephone exchanges, including discussions arising from shareholder proposals on climate change.

Exxon's greater willingness to engage so deeply in the debate on climate change is a significant step forward for the company and the industry.
We are pleased that the company has been so publicly open on its position on climate change and willing to discuss it in detail. It has rejected emission

reduction and intensity targets across its business – as have most of the oil and gas majors – but has explained that each business unit has efficiency targets. In certain cases these will for now not include reductions and the company has been able to persuade us that this is legitimate at least for the moment. Exxon has certainly helped us and other investors understand the issues facing the oil and gas industry. For example, we agreed with the company that switching from coal to gas is one of the most important actions that can be taken quickly to reduce greenhouse gas emissions and, as a significant bi-product, improve air quality. Like the International Association of Oil & Gas Producers (IOGP), Exxon believes that a revenue-neutral, market-based carbon pricing system is the best mechanism to reduce carbon emissions but like the IOGP it falls very slightly short of publicly advocating a carbon price. We have recently encouraged the company to support carbon pricing publicly and explicitly and to use its influence on the IOGP to follow suit. Some of the other oil and gas majors have made such a public commitment and we believe that it should be at the edge of evolving best practice in the industry.

We support the shift towards a meaningful and progressive carbon price globally. We further argue that the oil and gas industry should work hard to support such a move. This will help the industry reduce the risk of more draconian and disruptive public policy action in the future. It will also pave the way for investment in carbon capture and storage and other technology that will reduce the industry's own direct emissions and those of its customers, reducing the long-term risk to asset owners.

We look forward to continuing our dialogue with Exxon Mobil and its oil and gas peers, as well as with other important players in the climate change debate. We seek to encourage changes in public policy to develop meaningful and progressive carbon pricing internationally to reduce greenhouse gas emissions.