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Q&A for Investors on Stewardship Codes

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Q&A FOR INVESTORS ON STEWARDSHIP CODES

Around the world, new investor stewardship codes reflect a growing demand for responsible investment practices and sustainable value creation. The codes reinforce the role of institutional investors in overseeing the long-term success of their investments, promoting sound governance, effectively fulfilling their fiduciary duties, and maintaining transparency in the investment process. Stewardship codes are a key part of the evolution towards sustainable capital markets, but for many investors, stewardship remains an elusive concept. What is stewardship? Why does stewardship matter for an investor? And how can investors take action? Below, we offer some answers to some of the most common questions we receive from clients seeking advice.

What is stewardship?

Stewardship refers to a set of mechanisms or 'tools' that investors can utilize in order to enhance the quality, sustainability, and financial performance of their investments. These mechanisms include but are not limited to: engagement with management and corporate boards, filing shareholder proposals and voting, participating in public policy consultations, stock picking and divestment, and taking collective action through investor-led initiatives (e.g. Climate Action 100+ and the Principles for Responsible Investment). To date, stewardship has gained most traction in equities, but every asset class has various leverage points for investors to consider.

What are stewardship codes?

Stewardship codes differ by jurisdiction but typically offer guidance to investors on the following:

- Encouraging proactive monitoring of and engagement with investee companies.
- Promoting transparency in the investment process. For instance, disclosing policies and reporting on outcomes from engagement, voting and other stewardship activities.
- Integrating financially material 'ESG' (environmental, social and governance) factors in the investment process. For example, investors can consider how climate risks will affect their portfolio performance.

The UK Stewardship Code was the first code to be adopted in 2010, with all UK-authorised asset managers being required to produce a statement of commitment to the UK Stewardship Code or explain why it is not appropriate to their business model. Since then, many more jurisdictions have followed suit, including Brazil, South Africa, Canada, and India. in the European Union, the revised Shareholder Rights Directive (SRD II) came into force in June 2019. Meanwhile in the US, a group of investors with over $31 trillion in assets under management set up the Investor Stewardship Group to provide a set of stewardship principles for institutional investors and a complementary corporate governance framework for publicly-listed companies.

Why does stewardship matter?

Our recent research in collaboration with Ceres and the Environmental Defense Fund found there is compelling evidence that stewardship leads to outcomes – both in terms of improving corporate ESG performance and driving better financial performance.

Some examples of stewardship outcomes include:

- Research on corporate social responsibility engagements with US public companies over the period 1999-2009 shows that after successful engagements, companies experience improved accounting performance and governance.
- An analysis of the stock performance of 188 companies placed on the 'focus list' for ESG engagement by California Public Employees' Retirement System (CalPERS) found that they performed significantly better (15.27 percent above the Russell 1000 Index).
- Results from Ceres show that when investors negotiate withdrawals of shareholder proposals in return for company commitments, over 70% of these commitments lead to concrete outcomes.
- Evidence from collaborative dialogues involving 225 investment organizations (all signatories to the PRI) over the period 2007-2017 shows that after successful engagements have occurred, target companies experience improved profitability (as measured by return on assets), while unsuccessful engagements demonstrate no change.

How can investors take action?

Investors should see their role as 'stewards' as a critical part of the investment process and fully integrated in their fiduciary duties. As the evidence shows, stewardship can be conducted in a manner that enhances financial returns, promotes the long-term success of investments and safeguards capital from emerging social and environmental risks like climate change. For any investor considering what they need to do to strengthen their stewardship efforts, below are some suggested best practices:

- **Establish clear policies** – As a starting point, stewardship practices can be formalized in policies that clarify the organizational approach. Policies are increasingly being requested by clients and serve as a useful tool for communicating expectations to employees.
- **Report on outcomes** – Effective stewardship should focus on outcomes, and investors can expect more demand for quantifiable performance metrics to increase over time as stewardship practices evolve, demand for transparency grows, and clients continue to get more specific with their requests.
- **Rethink governance** – The emergence of stewardship codes has been coupled with the development of new corporate governance codes and principles. Despite reforms since the 2008 crisis, governance continues to fall back into the spotlight regularly for being ineffective. Board oversight of sustainability and deeper investor engagement with boards will therefore continue to evolve and adapt to new risks and opportunities such as those posed by climate change, data security and social inequality.
- **Develop an end-to-end strategy** – Stewardship and sustainability should not be confined to the periphery of the investment strategy but rather integrated throughout. Forward-thinking investors are now developing end-to-end strategies that seek to align sustainability and financial performance, facilitate capital allocation decisions and help build internal capabilities.

Conclusion

Stewardship codes might sound like an additional reporting burden for investors, but their value shouldn't be underestimated. Stewardship is a valuable part of the investment process and, when done right, is shown to deliver better financial returns and stronger sustainability outcomes. Ultimately, stewardship is about being prepared for the future, whether that relates to the transition to a zero-carbon economy, the switch to plant-based diets, the acceleration of technological change, or any other emerging trend. Now is the time for investors to embrace their stewardship duties.

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About KKS Advisors

KKS is a leading advisory firm specializing in sustainable finance, formed with the vision to reshape markets. Our goal is to enable clients to create sustainable and long-term value through the holistic integration of financial, environmental, social and governance factors.

For more information on KKS Advisors, visit www.kksadvisors.com

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