Active engagement, activism & our roadmap for driving more impactful change

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We believe in the power of friendly, active engagement to drive investment returns, and consider it an especially powerful driver of out-performance in emerging markets.

Whilst many investors are beginning to engage with portfolio companies, this article explains the four pitfalls of engagement and our strategy for overcoming them.

The power of Active Engagement vs. Activism

Activists have an increasingly troubled reputation. Glorified by Hollywood through the portrayal of brash, aggressive and glamorous alpha individuals, they captured the zeitgeist of unbridled capitalism and 'value creation' at any cost. Think ***Wall Street, Billions*** and indeed the meme-friendly Logan Roy of ***Succession*** – the bloody battle between beleaguered corporate executive and their hedge fund foes makes for captivating viewing.

But as we've argued before[1], such approaches to engineer change are becoming increasingly outdated. Boards, management teams and other institutional investors will rightly question the intent of such proposals. They will query what 'value creation' should mean and the investment horizon against which it must be judged. Fears grow about short termism, financial engineering and an opportunity set shaped by underperforming, low quality businesses.

Alex Edmans[2] writes that true value creation is achieved through 'growing the pie' rather than 'splitting the pie'. Firms create long term value by positive relations with stakeholders – customers, suppliers, regulators, employees – where long term earnings power is maximised by good treatment of all actors. Decision making should focus on activities which have social benefits to stakeholders that exceed its private cost, which utilise the firm's core competencies, and drive material benefits that flow back to the enterprise.

[1] https://gibam.com/assets/Engagement-in-Emerging-Markets_Final.pdf
[2] "Grow the Pie: How Great Companies Deliver Both Purpose and Profit", (Edmans, 2020)

For us, focused on emerging markets, a friendly approach to engagement to engineer change has proven to be superior. Cultural differences, less legal shareholder protection, tightly held ownership and potentially fewer supportive private fund managers are characteristics common to emerging markets. However, beyond that, it is becoming clear that a more effective and efficient method of engagement is to drive change through seeking friendly partnership with management teams. Our interactions begin with humility whilst we employ a significantly longer term horizon with an unswerving ambition to improve alignment. Once improved alignment is introduced, shareholders can benefit from such companies with inherent incentives to unlock value and embark on initiatives to drive greater market recognition of this value.

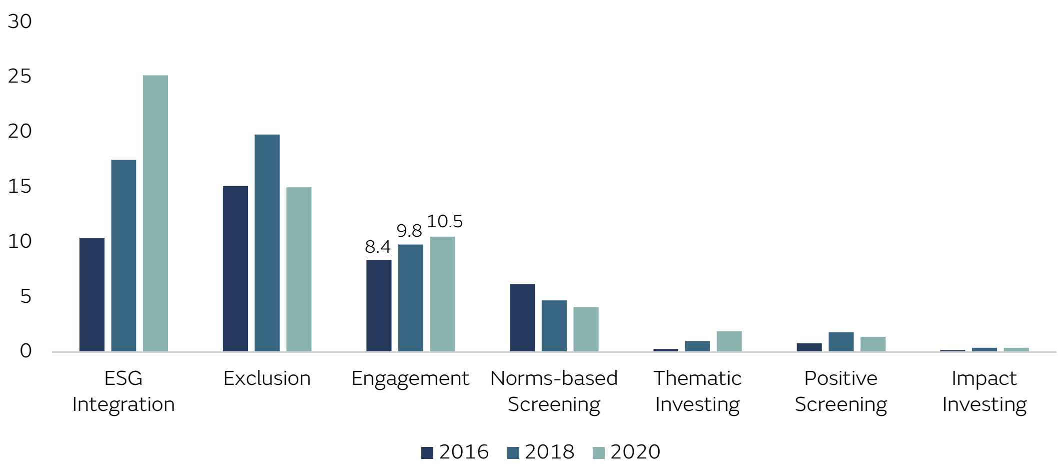
A longer investment horizon is necessary for the compounding power of such changes to manifest. This leads us to focus on high quality companies that are undervalued – not because of core fundamental deficiencies, but due to a deficit in terms of governance, capital allocation, disclosure, their approach to material environmental issues and strategic urgencies which we believe are fixable. The overarching concept of 'growing the pie' is central to such engagement priorities. It is the power of ideas, rather than the muscle of voting power, that is central to achieving material engagement outcomes.

Our differentiated vision for the future of engagement

Our team has long championed the merits of such an Active Engagement approach. Our process has led to tangible outcomes across emerging markets which have resulted in higher free cash flow compounding power and/or a lower implied cost of capital. These changes have been instrumental in terms of driving higher justified valuation multiples.

Momentum is now building globally in this form of investment strategy. As global ESG investing continues to grow in size, strategies that incorporate 'Engagement' have swelled to the third largest ESG investment strategy after ESG Integration and Exclusion. Funds that employ the engagement approach manage $10.5tn in assets, up from $8.4tn in 2016[3]. Whilst the numbers are materially smaller in emerging markets, we anticipate the trend to accelerate since the most material ESG engagement outcomes remain in the emerging world[4].

Global ESG investing AUM by strategy ($tn)



Source: 2020 Global Sustainable Investment Review

[3] 2020 Global Sustainable Investment Review
[4] https://gibam.com/assets/Engagement-in-Emerging-Markets_Final.pdf

However, whilst increasing recognition of the merits of such an investment strategy is important, we believe investors must remain vigilant about emerging engagement greenwashing, or ‘engagement-washing’. As ESG investing snowballed over the last decade, investors have been rightfully careful to navigate and sidestep investment solutions that were in name sustainability-aligned, but in practice were often rather loosely so. In response, those strategies that are genuinely sustainably-aligned have clearly articulated what full ESG integration should and must mean. With signs of similar mislabelling arising with engagement strategies, we would argue that authentic engagement needs to follow the same path.

Recent studies from the ECGI and UN PRI[5] share some interesting insights[6]. Data was accumulated from institutional investors that spanned 1,712 engagements across 573 firms between 2005 and 2018 with assets under management in excess of $1tn. Engagement focussed on governance improvements (43% proportion) with the remainder allocated to environmental (22%), social (20%) and strategic (16%) issues. However, it seems not all engagement strategies are equal.

We believe that there are four areas for potential improvements across the engagement landscape.

1

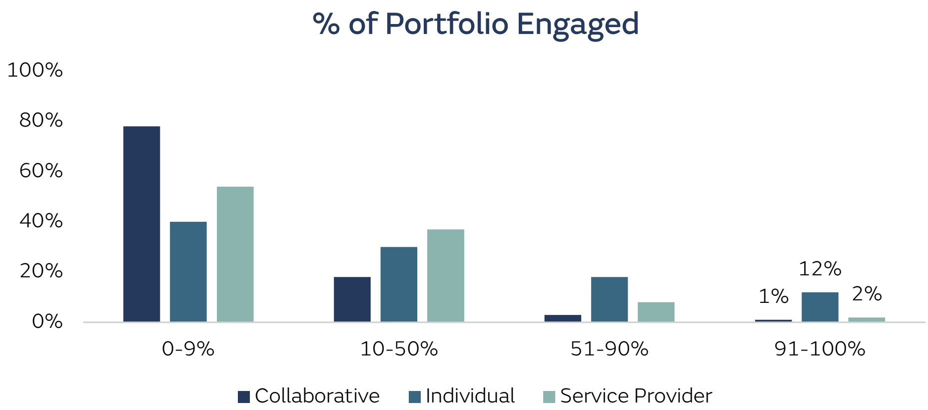
Less reliance on third party service providers

42% of UN PRI signatories continue to use primarily third party service providers for their method of engagement. This contrasts with our approach that is bespoke, targeted and focused on the sources of mispricing that we believe can be unwound.

2

Portfolio wide breadth of engagement

It appears that only a fraction of investors have engaged with the majority of their portfolio companies. As of 2020, only 30% who engage individually have engaged with the majority (>50%) of their portfolio companies. Of those that engage collaboratively, this figure falls further to 18%. Similarly, only 12% of investors individually engage with more than 90% of their portfolio, whilst only 1% do on a collaborative basis.



Source: UN PRI, 2020

[5] UN PRI, 2020
[6] “ESG Shareholder Engagement and Downside Risk”, (ECGI, 2022)

This is at odds to what we believe an Active Engagement strategy should represent. For us, active management in emerging markets integrates engagement across each company in our portfolio. We consider a more comprehensive and differentiated approach to invest exclusively in companies for which potential change through engagement is central to the investment thesis. The resulting concentrated and focused portfolio is undiluted – with returns generated through unlocking inefficiencies and underappreciated value. This, it seems, differs from the majority of peers who are selective about engagement. Instead such investors seek to drive change in pockets of their portfolio on a case by case basis usually only after challenges appear.

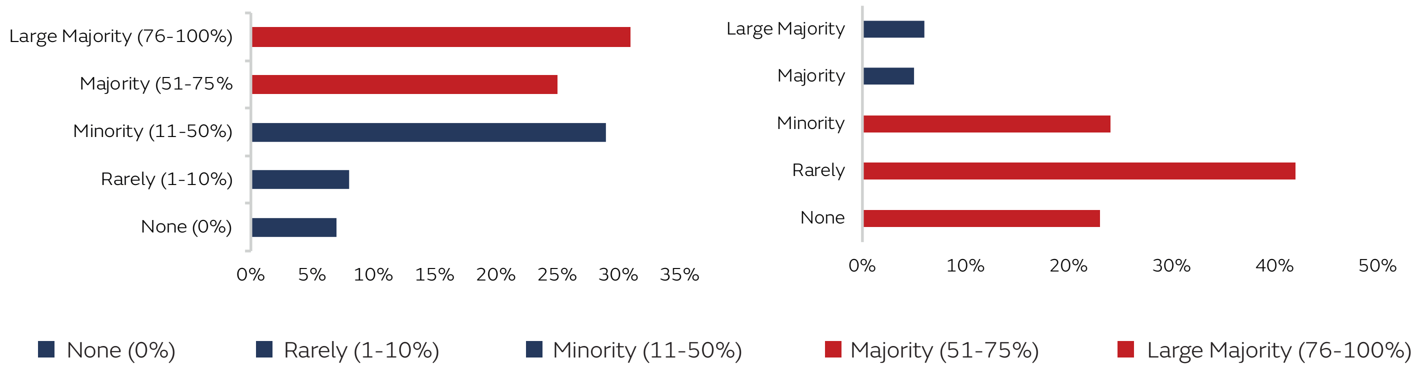
3

Real depth to engagement

Data from the ECGI and UN PRI studies shed light on the differing depth of engagement. 56% of the signatories state the majority of engagements involve only one interaction while only 11% confirm that the majority of their engagements involve 4 or more interactions with management. As engagement takes multiple years, recurring engagements over a longer term horizon are necessary to deliver and drive real impact. Since 2018, our strategy has embarked on more than nine interactions on material engagement points with each company across the entire portfolio.

Proportion of engagements that involve only one interaction

Proportion of engagements that involve 4+ interactions



Source: UN PRI, 2020

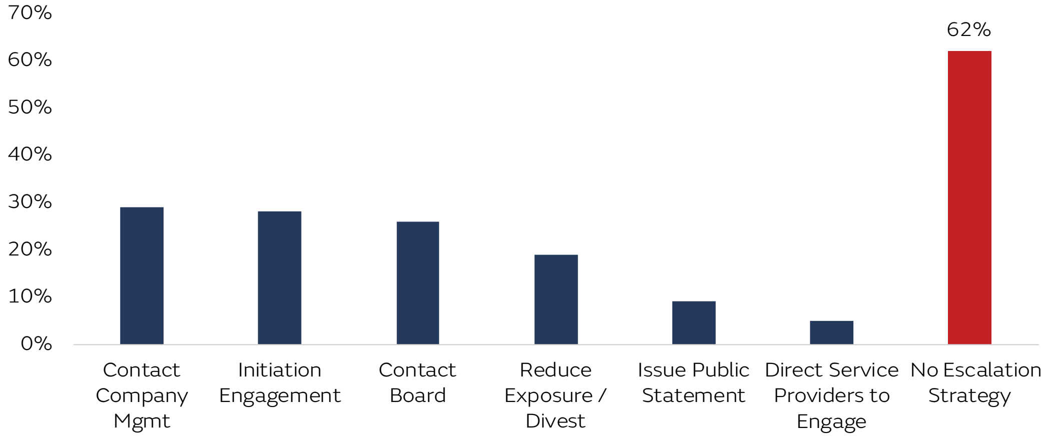
4

Detailed and committed escalation strategies

The engagement journey – despite being founded on friendly terms – can require perseverance, two-way discourse and commitment. Surprisingly, more than 60% of UN PRI signatories do not have an escalation strategy to continue to engage with management after unsuccessful votes. This feels unsatisfactory.

ASSET MANAGEMENT

Escalation strategies used after unsuccessful vote



Source: UN PRI, 2020

Conclusion

Whilst we are encouraged by the shift towards Active Engagement as a core driver of long term sustainable returns, investors should be discerning. Using engagement merely as a box ticking exercise can limit the true power of the investment strategy.

For us, friendly Active Engagement should remain the central driver of a businesses investment thesis and return profile, rather than being an afterthought once something has gone wrong. It should be deployed across the portfolio rather than on a case by case basis. Bespoke action plans should be crafted that address the most material issues to unlock hidden value and drive greater market recognition of it, rather than a singular reliance on proxy voting. Future articles will explore this in more detail with case studies across our portfolio.

So whilst our less glamourous approach of private interaction with companies – through presentation decks, recurring open discussions and whitepapers – is unlikely to entice the Netflix production teams to come calling, we find some solace that it's increasingly a more effective way to achieve what we've set out to do.