HYMANS ROBERTSON

Responsible Investment *News and Views*

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We want to help investors create positive impact. To be confident they're achieving this, investors must be able to demonstrate that their impact is legitimate. Our IxA framework is a novel approach that can help with monitoring and determining allocations between impact themes and asset classes. Excitingly, it could help have more impact.

Many asset owners are just starting out on their impact journey. When making allocations, it's still uncommon for investors to ask their asset manager to estimate upfront the amount of impact they'll achieve. Without these targets, monitoring becomes difficult. Asset owners know their manager is going to report on (say) greenhouse gas emissions. But with no target, how can an investor know if 10,000 tonnes of emissions averted is a good outcome?

Target setting should be positive, allowing for more effective monitoring. But it should also be approached carefully. For example, consider if an impact target is expressed at the level of the investee company (eg X tonnes of greenhouse gas emissions averted or Y people who are no longer homeless). What might the consequences be?

The immediate effect is that investors will crowd towards the companies/investees that are having the most positive impact. To a certain extent, this is a good thing. However, too much of a good thing could lead to crowdedness. If everyone starts throwing too much money at the most impactful companies, then it could create market distortions and cause capital to be misallocated.

Companies receiving more capital than is sensible could make unwise decisions that, in turn, lead to impact being diluted or even undermined. Further, capital may be withheld from other companies with the potential to create similar levels of impact. These are legitimate concerns at a systemic level. However, from the perspective of a specific investor, if you're allocating capital where it's not needed, you're not having impact.

This is the goal of the IxA framework, which evaluates how much impact you, the investor, are having. Within this framework, the 'I' factor refers to the impact occurring at the level of the investee company. The 'A' factor quantifies how much impact the investor is having – ie how likely would it be that the impact would have happened anyway, even if the investor hadn't invested. **Investor impact can then simply be calculated as I × A**

Any investment can then be counted as an impact investment if the investor impact exceeds a given threshold. This could be set so that it significantly exceeds the amount of impact you have by investing in (say) a generic index fund with exclusions. But the approach also allows investors to compare similar investments, judge where their assets may have greater impact and allocate capital accordingly.

Avoiding crowdedness is just one of the benefits of employing the IxA framework. The process of estimating additionality alongside the discipline of asking managers to quantify potential impact should ultimately allow investors to approach impact investment with confidence. We'll be developing and implementing this framework over the course of 2024, and we'd be delighted to talk to all stakeholders about how the IxA framework can help create a genuine, and positive, impact.

SIGNIFICANT VOTES: AI IN FOCUS

Artificial intelligence (AI) has experienced an explosion in capability and, consequently, attention from investors over recent years. It already threatens to be a disruptive force, creating potential value for investors by also having consequential impacts for people. Potential benefits include improved productivity and management in areas such as logistics, healthcare and financial services. But there are also risks that need to be considered, including the creation and propagation of misinformation, biased algorithms leading to discrimination, and a lack of transparency in decision-making. And that's just scratching the surface.

Given its potential systemic impact, AI is one of our ongoing focus themes in scrutinising asset managers' stewardship actions and corporate activity. We believe that by engaging with companies, investors and asset owners can help mitigate the risks posed by AI, particularly ahead of any regulatory intervention.

Taking it to the vote

Voting is a powerful instrument in the stewardship toolkit. The emergence of AI as an engagement focus was reflected in the 2023 proxy season, which saw the first shareholder resolution on the topic tabled at Microsoft's December Annual General Meeting (AGM).

Arjuna Capital, a US-based activist investor, filed the resolution, asking Microsoft to report on how it's managing financial risks and those to "public welfare" that may arise from AI. Arjuna Capital is primarily concerned about the role of AI in facilitating the dissemination or generation of misinformation and disinformation. Arjuna has engaged on the topic of misinformation for several years but has noted that the emergence of AI raises new questions about where responsibility lies.

The shareholder proposal asked Microsoft to "Report on Risks Related to AI-Generated Misinformation and Disinformation". Proxy advisor Glass Lewis did not support the resolution, noting that Microsoft's existing and planned disclosures are "sufficient to allow shareholders to understand how the company is managing and mitigating AI-related risks". ISS also opposed the resolution in its main policy, although it backed the resolution in its dedicated SRI voting policy.

The proposal was not successful, but it gained the support of 21.2% of shareholders. This is an impressive feat, given it was a first-of-its-kind proposal, and ensures that the subject is likely to remain in focus.

Several asset owners have publicly shared their voting decisions, including Aviva Investors; Wellington Management; Credit Suisse Asset Management; Allianz Global Investors; and Norges Bank Investment Management, Norway's sovereign fund; all of whom voted for the resolution. Norges went as far as to predeclare its voting intention ahead of the AGM, noting that it supports resolutions that ask for reasonable disclosure when it believes them to be well founded.

Beginning a period of scrutiny

The Microsoft resolution represents the start of what's likely to be an increasing focus on AI. Heading into the 2024 proxy season, shareholder resolutions on AI transparency have been filed at Apple, Comcast, Disney, Netflix and Warner Brothers Discovery.

AFL-CIO, the US trade union, is behind these resolutions, noting that increased AI transparency will fight "dehumanisation of the workforce". Its view is that as companies introduce AI technology into their workflow, they also introduce a variety of significant social policy concerns. Key risks cited include the potential for discrimination in employment decisions, mass layoffs due to job automation, the misuse of customer and employee private data, and the creation of 'deepfake' media content to disseminate false information. Of particular concern is the potential use of AI by the entertainment industry to create literary material and replace human performances.

The shareholder proposals ask companies in the tech and entertainment industries to publish a transparency report on whether they've adopted any ethical guidelines to protect workers, customers and the public from harms related to the use of AI.

Apple and Disney both sought to exclude the proposal from their annual proxy statements, arguing that the proposal concerns their ordinary operations. To do so, they pursued the SEC's 'no action' process, a mechanism by which companies ask the regulator for its permission to omit a shareholder proposal from going to the vote. Both companies contended that the resolution went against the SEC's rule on micromanagement by overstepping and interfering in the day-to-day running of business.

The SEC disagreed in both cases, commenting that the proposal "transcends ordinary business matters" and did not equate to micromanagement. This means that the proposals will be added to the proxy statements, and shareholders will have the opportunity to vote for increased AI disclosures.

These resolutions provide an opportunity for asset owners to open a discussion with their asset managers to understand how they're considering not only the potential benefits but also the potential risks of AI. To facilitate this conversation, why not ask your asset manager how they intend to vote on these resolutions, and the rationale for their decisions. You might also ask them if they're considering updating their stewardship policies to include AI considerations, given the increasing relevance of the topic.

ESG SNIPPETS

IIGCC publishes Net Zero Voting Guidance

The Institutional Investors Group on Climate Change (IIGCC) recently produced Net Zero Voting Guidance to help support asset owners and asset managers in developing their own net-zero policies and voting practices. The guidance outlines three core principles for net-zero voting. According to the IIGCC, voting should: align with the investor's own net-zero objectives and targets; communicate net-zero expectations; and support net-zero stewardship, engagement and investment approaches. Therefore, the aim of the IIGCC is to encourage clear voting policies on net zero from both asset managers and asset owners alongside investors through the Net Zero Investment Framework.

Asset owners who have set net-zero ambitions should ensure they review their voting policies against the guidance. Where policies diverge, this offers the potential to make changes, or to engage with asset managers as necessary.

FCA publishes sustainability labelling policy

In December 2023, the FCA published its policy statement on Sustainability Disclosure Requirements (SDR). This uses an investment labelling regime for sustainability products. One key change was an increase in the number of labels, allowing for 'mixed sustainability' products. At the core of these regulations is the mission to combat greenwashing, by fostering better transparency for investment vehicles that promote themselves as sustainable. Asset managers have some time to implement the requirements, which will be progressively introduced. While the requirements focus on the retail market, it's likely that managers will strive for broader consistency in product development.

We have long cautioned that investors should understand what sustainability means when making allocations to such products, and we've developed our own evaluation framework to support our research and advice. As we're already seeing managers review product names, asset owners may want to ensure that they understand whether a product 'does what it says on the tin'.

ExxonMobil sue to block climate proposals

ExxonMobil filed a lawsuit at a US district court in Texas, citing that the climate proposal put forward by the green activist investor group, Follow This, violated the SEC's investor petition rules. The proposal asks the US oil giant to accelerate attempts to cut greenhouse gas emissions. ExxonMobil has asked the court to decide by 19 March, ahead of its AGM on 29 May 2024. This lawsuit may set a precedent for energy companies who are lagging in their approach to addressing climate issues and thus subject to increased scrutiny over the robustness of their climate policies. Given the current anti-ESG sentiment in this US, such lawsuits could hamper both investor engagement and broader policy initiatives.

Identifying potential climate laggards and taking steps to hold them accountable for their actions is a key element of a climate transition action plan. Collective engagement can continue to support the process of change.

Addressing marine biodiversity

The ocean, covering 70% of the Earth's surface and holding 97% of all water, is critical for life and plays a vital role in climate regulation. The 'blue economy,' valued at $2.5trn annually, encompasses marine activities such as renewable energy, shipping and fishing, making oceans the seventh-largest economy by GDP, with assets estimated at $24trn.

Despite the growing interest in sustainability from businesses and investors, awareness of the ocean's role in combating the climate and biodiversity crises remains low in the global investment industry. It's crucial that the momentum towards sustainability does not neglect the ocean and marine biodiversity. The recent launch of an ocean life engagement theme by engagement specialist Robeco was a positive step in this regard.

To help investors build knowledge on this subject, we've published a deep dive into the topic and a two page summary that picks out the salient points. For asset owners taking steps to address biodiversity, we'd encourage adding this topic to the training agenda.

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