The role of engagement in sustainable investing

In short The AFM considers it important that investors who want to invest sustainably have access to reliable information. This includes a realistic picture of the role that engagement can play within a sustainable investment strategy: what can and cannot be expected from this instrument? This exploratory study looks more specifically at how asset managers carry out their engagement activities and how effective they prove to be. We show that science and practice view the concept of effectiveness from different perspectives. We also find that effectiveness is difficult to demonstrate, but that engagement can nevertheless be a valuable tool within a sustainable investment strategy. We offer four insights that can be helpful in clearly substantiating the value case for engagement. Finally, we identify ten factors that can contribute to the success of engagement.

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Introduction

An important way for asset managers to implement sustainable investing is through what is known as ESG engagement. Through engagement, the asset manager uses its position as a shareholder to persuade companies to behave more sustainably. Engagement often complements another pillar of a sustainable investment strategy, namely various forms of selection within the investment universe, such as excluding polluting companies or including sustainable companies. Although sustainable investing often emphasises aspects related to climate change, in this exploratory study we use the broad 'ESG' concept of sustainability that includes environmental (E), social (S) and governance (G) aspects.

Reliable information for sustainable investment is an important aspect of the AFM's supervision of sustainability. Investors need sufficient, reliable information in order to ascertain whether their ESG preferences are met. It is important to avoid a mismatch between the sustainable investors' expectations and the actual ESG performance of their investments. It is therefore important that investors have a realistic view of the role that engagement can play in a sustainable investment strategy. Asset managers' engagement reports suggest that engagement can generally be seen as a successful contribution to their sustainable investment objectives. In order to better assess the value of such claims, we first need more insight into how engagement actually works and what we can and cannot expect it to deliver.

This exploratory study specifically aims to provide insight into how asset managers put their engagement activities into practice, its effectiveness and the factors that influence the success of ESG engagement. The findings included in this study are based on an extensive analysis of the academic literature on ESG engagement and on twenty interviews. The interviews were conducted with academics and experts in the field of sustainable investing and ESG engagement, with partnerships of sustainable investors and with engagement specialists in asset management firms.

Reading guide
This exploratory study is structured as follows. After the executive summary, Chapter 1 introduces engagement in more detail and positions engagement in the broader toolbox for sustainable investing. Chapter 2 discusses the effectiveness of engagement and the challenges involved in measuring it. Chapter 3 discusses the factors that can promote the success of engagement.

Executive summary

Effectiveness of engagement

Engagement is an important tool used by asset managers to implement their sustainable investment strategy. It requires considerable capacity, resources and people and is therefore a serious asset management activity.

Practice and science view the effectiveness of engagement from different perspectives. The empirical-scientific perspective (logically) has a strong focus on objective measurability of effects. Empirical research indicates that engagement has a (slightly) positive effect on a company's ESG behaviour. For example, there are indications that engagement improves corporate disclosure about climate risks. Engagement also seems to be capable of exerting a – moderately – positive impact on the management of ESG risks and hence on the company's financial performance (financial materiality). At the same time, the scientific literature yields limited empirical evidence of the real-world impact of engagement (impact materiality). The fact that any effects can never be causally attributed to engagement activities also makes them intrinsically difficult to measure. The absence of a demonstrable causal relationship implies that caution is required when claiming positive effects of engagement.

Asset managers focus less on this measurability. They tend far more to view their efforts from a theory-of-change perspective and judge their effectiveness accordingly. Within that perspective, success is measured by, for example, committing a company to better disclosure on a particular ESG theme or a commitment to achieve net zero in the long term.

Although effectiveness is difficult to demonstrate, engagement may contribute to a sustainable investment strategy. Given the measurement problems, a requirement for hard (empirical) substantiation of effectiveness may set the bar unreasonably high. Engagement may have indirect, longer-term effects that (for now) are difficult to measure and quantify. Specific ESG-promoting measures aimed at, for example, strengthening the provision of information, governance or policy are useful, small steps forward and represent a push in the right direction. To assume that such measures will ultimately have real world impact seems a logical way of reasoning.

It is important that engagement reports set the tone carefully, so as not to raise unjustified expectations about effectiveness. Many engagement reports start by expressing the ambition of achieving real-world impact through engagement. Even though they avoid attributing this type of impact (i.e. claiming causality), the case studies highlighted by some asset managers and the reported success rates – taken together – may suggest some degree of causality. Experts therefore see a risk that such a promotional tone could raise unjustified expectations amongst investors. It should be noted that the reports present a variety of approaches and definitions and vary greatly in depth and form. This lack of clarity makes comparability difficult.

An analysis of success factors

Our analysis shows that prioritising the quality of engagement efforts over quantity is a key success factor. In order to have a serious dialogue with the company, the asset manager must have a deep knowledge of the company's business model and an understanding of how the sustainability transition affects it. Knowledge is also needed of how the company relates to its peers and of the steps needed to develop further in the transition (know-what-you-own). This makes engagement a knowledge- and capacity-intensive process, making it impossible for an asset manager to engage across the entire portfolio. A key success factor for the quality of engagement is therefore the limiting of engagement efforts to a select group of companies and focusing on a limited number of specific ESG themes.

Another success factor is a credible threat of escalation if the engagement efforts do not lead to the desired result. Exclusion is the most severe form of escalation, but this approach is open to question. The threat posed by this seems to be small, especially for large listed companies. As long as there is sufficient demand for the share and therefore other investors will step in, the effect on the company's capital costs will be limited and the 'pain' will therefore be slight. This lack of threat may hinder the overall effectiveness of the engagement dialogue. Engagement on asset classes other than listed equity may be more promising. Examples include private equity, where the relationship with management is much more direct, and debt financing, where obstacles to debt refinancing may cause more 'real pain'.

Engagement can contribute to transition financing, but involves an understandable selection bias. As a result, engagement focuses only to a limited extent on real 'laggards' in the transition. In practice, asset managers indicate that they focus their engagement programmes mainly on companies that are motivated to make the sustainability transition and are therefore open to engagement. In theory, this makes it possible that the company would take the measures pursued by engagement anyway, which may distort the effectiveness of engagement. As engagement is capacity-intensive, it is nevertheless logical that the focus is primarily on companies that are actually receptive to dialogue. Engagement mainly focuses on companies that are on their way to being 'green', so it can be regarded as an instrument that contributes to transition financing. It should be noted, however, that the selection bias means that the instrument is less likely to reach real laggards in the transition.

New corporate transparency rules such as the Corporate Sustainability Reporting Directive (CSRD) may support engagement, but asset managers also have reservations. The CSRD can facilitate engagement by making more company data available on ESG performance; currently only a leading group of companies provide such information. The mandatory standards also ensure greater comparability and consistency, making it easier to compare ESG performance. This can make it easier to identify companies for engagement and monitor companies' ESG progress. Potentially, this will also mean that asset managers' engagement efforts will not need to be focused so much on improving ESG disclosure in the future and can be shifted to other objectives. Nevertheless, asset managers also have reservations. CSRD compliance requires a great deal of effort from companies and this may hinder their capacity to implement engagement. In order to manage the transition through engagement, asset managers expect to continue to need additional ESG data on and an in-depth dialogue with companies in the future, in addition to public reporting.

Challenges and opportunities

The more negative sentiment around ESG presents challenges for engagement, but also presents opportunities. In the US – and to a lesser extent in Europe – sentiment towards pursuing sustainability goals through investment policy has turned much more negative. Asset managers say this 'ESG backlash' may result in certain topics no longer being 'engageable' in US companies (e.g. diversity or explicit climate commitments). As a result, the engagement approach will have to be more geographically diversified, which is at odds with the aforementioned importance of 'focus' in engagement. Nevertheless, the ESG backlash also offers opportunities: a more critical approach to sustainable investing ultimately benefits asset managers with a compelling, realistic engagement strategy that can actually provide the added value that asset owners are looking for in the ESG field.

The more critical attitude towards sustainable investing and the aforementioned complexity around demonstrating effectiveness increase the pressure on asset managers to do even more to clarify and substantiate the value case for engagement. In concrete terms, this involves providing insight into the resources used for engagement and the way in which these resources contribute to the engagement objectives.

More specific reporting on engagement efforts can help to strengthen the understanding of the engagement value case. The exploratory study offers four insights that could contribute to this:

- **Make clear how engagement is embedded in the overall sustainable investment strategy**. This involves, for example, showing that the engagement is consistent with the overarching investment beliefs, choices in the investment universe (selection/exclusion) and the exercise of shareholder voting rights.

- **Be transparent about the engagement methodology**. This includes transparency about which theory of change is used with which time horizon, how the incremental steps to be taken by the company fit into this and what the consequences are if the company does not make sufficient progress with regard to these steps.

- **Specify the materiality to which the engagement activities are primarily directed**. Is an activity mainly aimed at managing financial risks or real-world impact?

- **Provide more insight into the nature and quality of the engagement**. For example, with whom do you conduct the dialogue (CEO or investor relations officer?) and what is the degree of involvement in the dialogue (outsourcing to a service provider or active bilateral knowledge exchange?)?

Finally, engagement benefits from an environment in which incentives are more in line with the objectives pursued. The institutional environment in which engagement takes place has not hitherto been sufficiently successful in pricing the real environmental and social costs of economic activities (externalities). Examples include the consequences for climate and biodiversity. Until this market failure is better addressed, there will be limited price incentives to make sustainability pay. In this context, engagement can never be expected to deliver maximum effectiveness. Through field building – a collective term for engagement activities aimed at influencing a company's behaviour through interaction with stakeholders outside the company – the government can be encouraged to regulate or price these externalities.

1. Engagement as a tool for sustainable investing

In this chapter, engagement is placed in a broader context. We will discuss how engagement fits into the broader range of instruments for sustainable investing, what the underlying motivations are for engagement and how it takes shape in practice.

1.1 Engagement is part of a broader toolbox

Sustainable investing is a form of investment in which investors consider both sustainability risks and sustainability impact in their investment choices. This dual perspective of investors is encapsulated in the concepts of financial materiality and impact materiality, in other words the influence that sustainability risks have on the value of investment portfolios (financial) and how investment portfolios impact 'planet and people' (impact).

Sustainable investments can be directed to different asset classes. These include investments in both equity and debt and can be effected through public and private markets (Figure 1.1). Within these options, this exploratory study focuses on investments in the equity of public listed companies and how this specific investor relationship can be used to influence the company's ESG behaviour.

Figure 1.1: Sustainable investing can target different asset classes

	Sustainable investment options			
	Equity		Debt	
	Public	**Private**	**Public**	**Private**
Investee entity	Public listed company	Private company	• Government related entity • Public listed company • Private company	• Public listed company • Private company
Investor/investee relationship	Owner (partial)	Owner (full or partial)	Contractual relationship (lender)	Contractual relationship (lender)
Holding period	Potentially unlimited	Potentially unlimited (typically 7-15 years for private equity funds)	Limited by bond tenor	Limited by terms of loan

Source: based on PRI (2019), adapted by AFM

Figure 1.2: ESG engagement is embedded in a broader set of tools for sustainable investing

ESG incorporation			**Active ownership** (stewardship)	
Considering ESG criteria in the composition of an investment portfolio			Interaction between investors and companies on ESG themes, with investors using their shareholder role to influence these companies' behaviour	
Integration	**Screening**	**Thematic**	**Engagement**	**Voting**
Taking account of ESG criteria (as well as financial criteria) when assessing the risk and return of the portfolio	Filtering potential investments on the basis of ESG criteria in order to include or exclude individual companies	Composing a portfolio with the intention of achieving a specific environmental or social outcome	Investor engages in dialogue with companies on ESG themes by means of letters, meetings etc.	Voting on, or submitting or supporting, ESG-related resolutions at shareholder meetings

Source: based on PRI (2021), adapted by AFM

Within the toolbox for sustainable investing, two main categories can be distinguished: ESG incorporation and active ownership. ESG incorporation relates to the consideration of ESG criteria when compiling an investment portfolio and is therefore also referred to as a pre-investment strategy. Active ownership (also referred to as stewardship) concerns activities in which the investor uses the shareholding to encourage the investee company to behave more sustainably (Figure 1.2) (PRI, 2021). Traditionally, active ownership has been directed to improving the company's general financial performance, strategy and governance. This study focuses on active ownership related specifically to ESG performance.

Central to ESG incorporation is the instrument of 'selection and exclusion'. Selection involves choices made to include sustainable companies in the investment universe or exclude (for example) polluting companies. Selection involves considering only companies with a certain minimum ESG performance. In the case of exclusion, companies in controversial sectors – such as tobacco, weapons or sectors with high CO_2 emissions – or companies in which controversies arise are not eligible for inclusion in the portfolio at all. Previous AFM research noted with regard to the effectiveness of exclusion strategies that, in practice, exclusion by individual investors rarely seems to restrict listed companies' access to finance (AFM, 2022).

Engagement is an important tool within active ownership focused on sustainability. ESG engagement refers to the dialogue that investors have with companies in their portfolio with the aim of improving their ESG performance. In engagement, investors do not exclude companies with low sustainability performance or companies in transition, but rather try to encourage them to become more sustainable on the basis of their shareholder relationship. Another instrument within active ownership is the use of voting rights at shareholders' meetings. The basis for active ownership is partly enshrined in law and partly based on voluntary commitments, including those laid down in stewardship codes.

Engagement covers a wide variety of activities and includes an escalation hierarchy. Dialogue with companies on ESG-related issues can take many forms, ranging from sending letters to formal consultations with the board of directors. In engagement activities, there is generally an escalation hierarchy. The escalation can ultimately result in the reduction of the equity position or even exclusion (see, for example, Bosma et al., 2022).

1.2 Motivations for engagement may vary

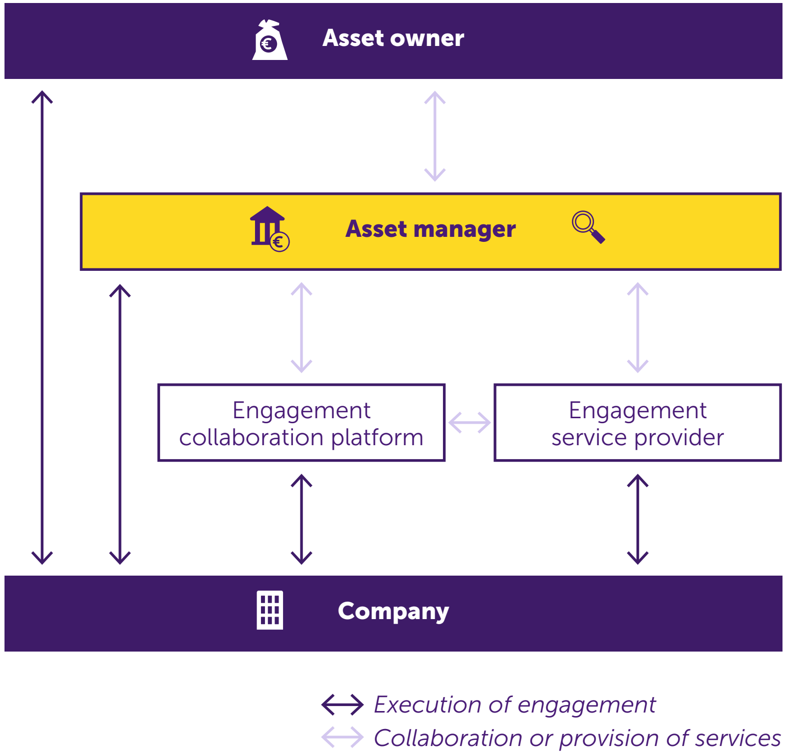
ESG engagement can be driven by a mix of motivations. The following motivations can be distinguished (based on PRI, 2022):

- *Financial materiality*. Engagement can be used to encourage proper management of ESG risks, thereby securing the company's financial return.
- *Impact materiality*. By using engagement to influence company behaviour (e.g. CO_2 reduction or respecting trade union rights), it is possible to pursue a specific ESG impact. For example, a real impact on climate change can be sought by focusing on a reduction in the company's CO_2 emissions.
- *Fiduciary responsibility*. Long-term value creation can be promoted by using engagement to encourage companies to adopt a sustainable, future-proof business model. This is in the interest of the asset owner and can be seen as a means of fulfilling the asset manager's fiduciary responsibility.
- *Compliance*. Engagement can be compliance-driven in the sense that asset managers must comply with legal frameworks for responsible ownership or want to comply with voluntary sector initiatives.
- *Public opinion*. Pressure from clients, politics and society – sometimes reinforced by media campaigns by NGOs, for example – can be a reason to take up or intensify ESG engagement (e.g. pension fund members demanding a more sustainable investment policy from their pension fund).

1.3 Engagement is conducted within a network of actors

Asset owners can outsource all or part of their engagement process to asset managers. Larger asset owners in particular (e.g. pension funds or insurers) determine their own sustainable investment policy, including the engagement policy, but the implementation of the policy is often outsourced to other actors such as an asset manager (Figure 1.3). The asset manager may then choose to outsource all or part of the engagement dialogue – for example, only for a specific ESG theme – to an engagement service provider. In some cases, asset managers and/or engagement service providers are also given responsibility for drawing up the engagement policy (Wagemans et al., 2018).

Figure 1.3: Several actors may be involved in the engagement process



Source: based on Wagemans et al. (2018), adapted by AFM

ESG engagement is often organised in partnerships. Collaboration allows the pooling of expertise and enables shareholder power to be combined to create additional leverage. In the Netherlands, institutional investors work together on engagement within the Eumedion network, for example. There are also various platforms for cooperation at the international level. An example is the PRI (Principles for Responsible Investment) collaboration platform, where investors can submit an engagement case on which they wish to collaborate with other investors. Collaboration also takes place at the level of asset managers and engagement service providers, as they often have several asset owners as clients. They combine engagement efforts across these clients and therefore represent several clients in their engagement dialogue.

The engagement process can also be directed to actors in the company's field of operations, which is also referred to as 'field building'. Engagement can also focus on parties that can influence the company's behaviour through other channels. This form of engagement is also referred to as being part of a 'field building' strategy (Marti et al., 2024). Field building can be defined as interaction by shareholders with stakeholders active in the 'fields' in which companies are embedded, thereby enabling them to exert influence on the company. The stakeholders with whom interaction can be sought are very diverse and may include fellow companies, policymakers, legislators and standard setters, NGOs and media. The possible field building activities are therefore also diverse, such as political lobbying, working with NGOs on voluntary standards or influencing public opinion through the media.

2. Effectiveness of engagement

Given the important role that engagement plays in a sustainable investment strategy, an important issue is what we can and should expect from it. When considering the effectiveness of engagement, we distinguish between a scientific perspective and a perspective from the asset managers' practice. Based on the literature review and the interviews, both perspectives are explained and compared in this chapter.

2.1 Scientific perspective focuses on empirical evidence

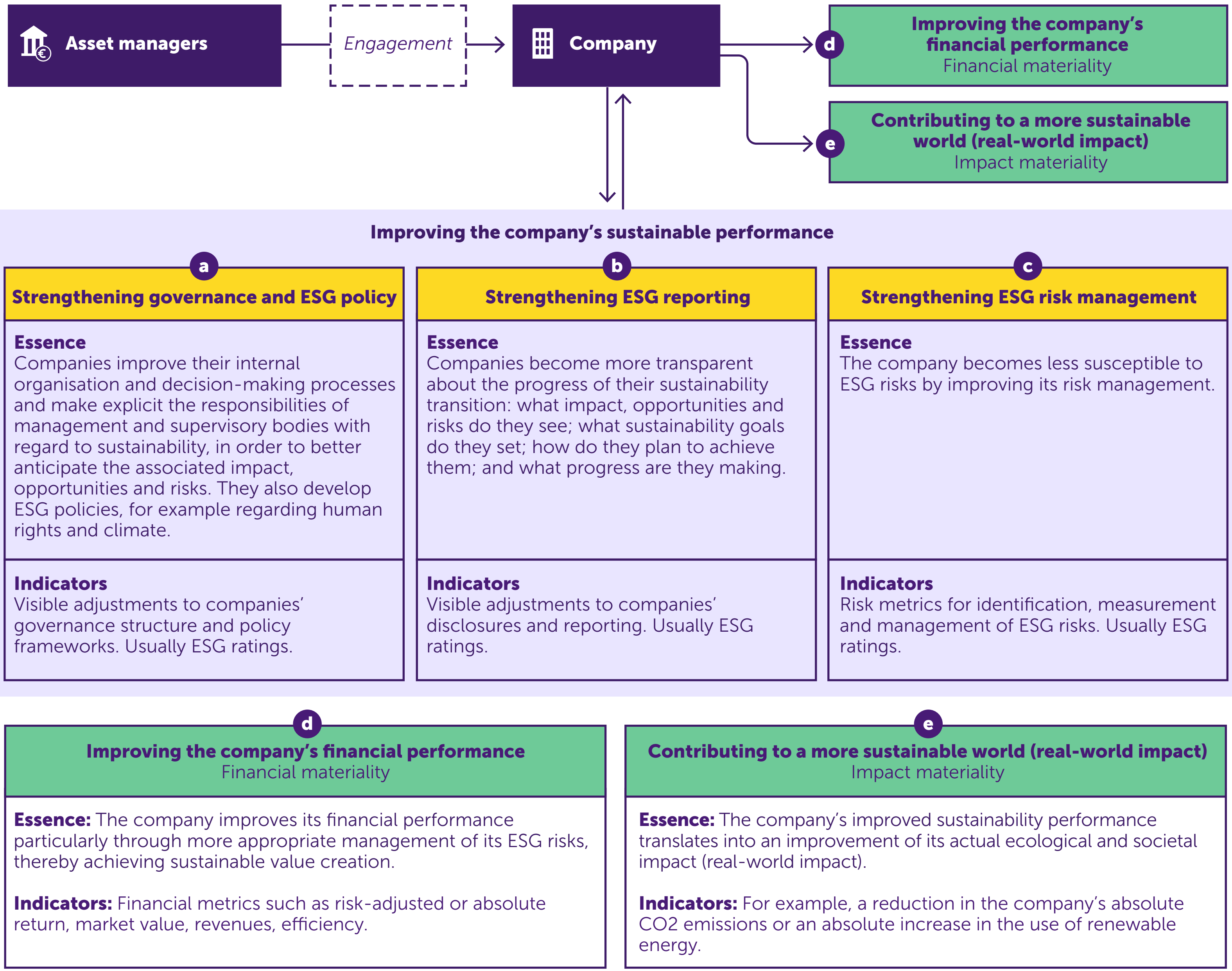
The empirical literature seeks to assess the effectiveness of engagement by measuring the extent to which the different objectives of engagement are achieved. Generally, the following objectives – which are further elaborated in Figure 2.1 – are distinguished:

- Strengthening the company's governance and the development of ESG policy (*part a* in Figure 2.1);
- Strengthening the company's transparency concerning its ESG performance, also referred to as ESG disclosure (*part b*);
- Strengthening the company's ESG risk management and hence the company's financial performance – financial materiality (*parts c and d*);
- Improvement of the company's actual environmental and social footprint – real-world impact or impact materiality, such as an absolute reduction in CO_2 emissions or human rights violations (*part e*).

An analysis of the literature and interviews shows that engagement can have a positive impact on the company's ESG behaviour. Engagement can contribute to better governance, the development of ESG policies and greater transparency on the part of companies concerning ESG. For example, there are indications that engagement on climate issues improves companies' disclosure concerning risks related to the climate transition and also leads to changes in the governance structure. Engagement can also contribute to greater policy ambitions and the setting of medium- and long-term objectives, such as on climate, human rights or employee protection. In addition, engagement appears to have a (moderate) positive effect on the management of ESG risks and hence on the company's financial performance – such as equity returns, profitability, revenue and operational efficiency. Thus, engagement in itself can have a positive impact on the company's ESG behaviour, often measured by ESG ratings (see, for example, Barko et al., 2022; Bonacchi et al., 2021 and 2022; Dimson et al., 2015; Dyck et al., 2019; Flammer et al., 2021; Grewal, 2016; Hoepner, 2020; Naaraayanan et al., 2021; Bellavite Pellegrini et al., 2024; Koedijk et al., 2020).

At the same time, a significant criticism from the academic side is that there is not yet any convincing empirical evidence that engagement leads to real-world impact or, in other words, to an improvement in the company's actual environmental and social footprint. For example, a number of studies show that despite the engagement efforts in the field of climate themes, no decrease can be seen in the total CO_2 emissions of the companies concerned (see, for example, Bauer et al., 2022; Busch et al., 2023; Derwall et al., 2022; Diaz-Rainey et al., 2023; Michelon et al., 2020; Hastreiter, 2024; Gosling, 2024). As such, there is as yet limited evidence that engagement also leads to a substantial and real improvement in companies' social and ecological impact.

Figure 2.1: Effectiveness of engagement - transmission channels



Source: AFM

In addition, measuring the effects of engagement is inherently difficult due to the limited availability of good data – for example, the commonly used ESG ratings do not seem to be a robust measure of sustainability performance. ESG ratings – typically provided by third parties such as MSCI, Sustainalytics and Bloomberg ESG – are composite indices that can include different themes (E, S and G) as well as different elements (e.g. emissions and resource use, but also quality of reporting and governance). An overall ESG rating is therefore difficult to relate to the much more specific sustainability goals that engagement is intended to achieve. ESG ratings may also focus disproportionately on one of the two sides of materiality (mostly on risks and not on impact). Moreover, how these indices are compiled, and which topics and weights apply to them, varies greatly from rating to rating. As such, it is not always clear exactly what is being measured. All this makes isolating the effect on a given goal of engagement complex and makes ratings and benchmarks difficult to compare, even with a clear picture of the company's sustainability performance.

Moreover, ESG ratings have limited explanatory power for companies' actual environmental and social impact. For example, as outlined earlier, a number of academic studies show that although some engaged companies show higher ESG ratings, their absolute CO_2 emissions show hardly any decrease. A possible explanation for this is that the use of ratings and benchmarks can create the wrong incentives. For example, the company may – deliberately or otherwise – mainly show policy and transparency improvements that improve ESG ratings, whereas the actual impact improvement is limited (Derwall et al., 2022). And there is also the risk that the company will not focus primarily on the ESG issues that are actually relevant to improving its sustainability profile.

Another measurement problem arises from the long term over which effects manifest themselves. Engagement is a long-term process. It takes a long time for it to have an effect and the actual impact of engagement may therefore not be measured sufficiently. In addition, engagement often takes place behind closed doors in the form of a private dialogue. These efforts are likely to prove more effective than more public forms of engagement (e.g. issuing a public statement) but are more difficult to measure due to limited data availability of these efforts.

Finally, measurement is complicated by the fact that it is virtually impossible to demonstrate and attribute causal links between engagement and a company's ESG performance. It may be possible to make a direct link to a very specific ESG engagement topic, but, in general, several factors (market or consumer pressure, regulation, political and social pressure) will influence companies' ESG behaviour. It is then difficult to isolate the influence of engagement. In other words, it is possible that ESG changes in companies would have taken place even without engagement. Correlation (contribution) is not the same as causality (attribution) and caution is advised when claiming effects of engagement. Because of this problem, the British regulator FCA stated last year that it would stop developing a KPI measuring the effectiveness of engagement: isolating the effect of engagement turned out to be too challenging.

2.2 Practice-based perspective derives from a theory of change

Engagement is an important part of the broader toolbox for sustainable investing by asset managers. As explained earlier, engagement is usually embedded in a set of sustainable investment instruments and is a consequence of an asset manager's investment beliefs. Engagement is therefore a key pillar of the overall ESG objectives pursued by asset managers. It requires considerable capacity, resources and people and is therefore a serious asset management activity. This also means that the services of an external manager (to which part of the asset management is outsourced) may be discontinued if the quality of its engagement activities does not meet the outsourcing asset manager's requirements. This poor quality may manifest itself, for example, in insufficiently strict and specific commitment requirements for investee companies, as a result of which they too often fail to take concrete action.

At the same time, it is recognised that the effectiveness of engagement is difficult to measure and demonstrate, especially with regard to real-world impact. Asset managers are also aware of the fact that absolute (causal) claims about the effectiveness of engagement are difficult to make and that restraint is required. In this context, some asset managers are assessing whether the effectiveness of engagement could be better measured by commissioning independent researchers to question the engaged companies. Informal feedback from companies often indicates that the engagement helped them to take steps in the ESG field. A more far-reaching idea could be that asset managers can only make certain claims about their engagement if the company in question acknowledges – preferably publicly – that its change in behaviour is the result of the engagement effort.[1]

However, the fact that effectiveness is difficult to measure and demonstrate does not mean that engagement is not a meaningful part of a sustainable investment strategy: asset managers emphasise that engagement contributes to companies' ESG change processes. In practice, engagement objectives largely relate to variables such as ESG disclosures or the development of ESG policies and objectives. Based on a theory of change (i.e. identifying the mechanisms through which specific steps contribute to a desired outcome), these must contribute to real-world impact.[2] In practice, engagement therefore focuses mainly on smaller, incremental steps that contribute to an ESG change process that a company is going through. Engagement can thus have indirect, longer-term effects, even if they are difficult to measure and quantify. They are a push in the right direction and, according to the asset management industry, it is logical to assume that they will ultimately have real-world impact.

The discussions reveal a number of factors that further substantiate the importance of engagement by asset managers. For example, it is emphasised that asset managers, as providers of capital, play an important role in encouraging companies to think about the larger systemic risks, for example due to climate change. In a broader sense, engagement also contributes to the further development of a framework of standards and expectations in which companies operate, which is gradually moving towards more sustainable behaviour. In addition, spillover effects may arise, as engagement efforts have contributed to the emergence of an entire ecosystem comprising everything from service providers and data suppliers to ESG benchmarks. Factors such as increased board awareness of ESG, ESG knowledge-building within the company and the development of an internal corporate culture focused on ESG are also often cited as indirect effects of engagement.

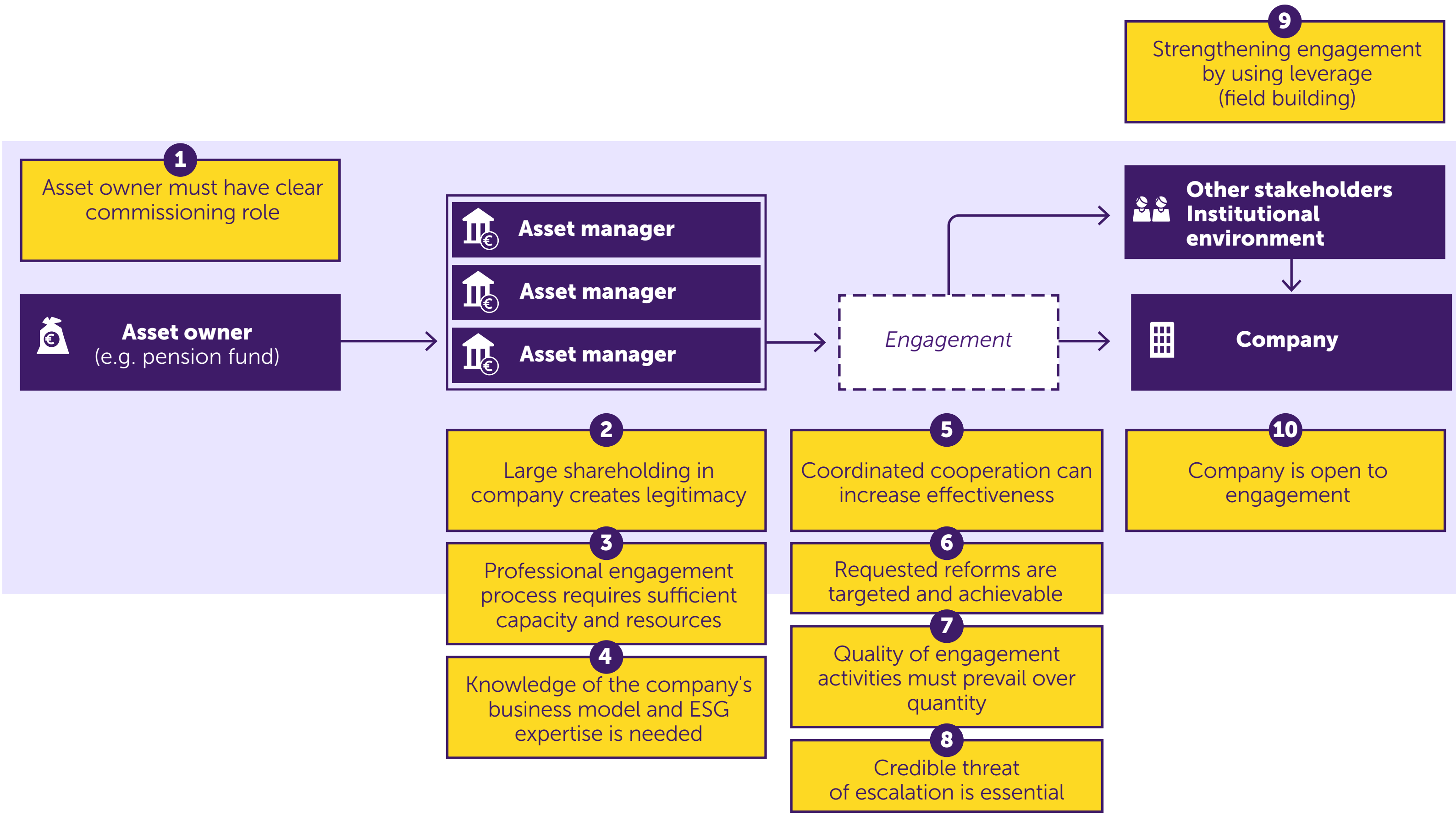
1 'Low-quality engagement a 'barrier' to accessing companies', Responsible Investor, 16 October 2024.

2 A theory of change is essentially a 'logical model' which shows how the activities of an organisation produce certain outcomes and how these outcomes contribute to certain results in an environment or system outside the organisation. In other words, a theory of change is used to describe what outcome you want to achieve and how you intend to do it.

3. Success factors for engagement

Based on the interviews and the literature, ten factors can be distilled that can positively influence the effectiveness of engagement. These success factors can be broadly traced back to distinguishing characteristics of (i) the asset manager, (ii) the execution of engagement in practice and (iii) the engaged company (Figure 3.1). Here too, these success factors can be viewed from different perspectives (theory and practice) and some success factors are open to question.

Figure 3.1: Ten success factors for engagement



Source: AFM

3.1 The asset owner must have a clear commissioning role

The commissioning of the asset manager by the asset owner (such as a pension fund) is an important precondition for successful engagement. An asset manager's use of engagement to pursue ESG outcomes, such as reducing the company's climate footprint, must be in line with the investment goals or horizon of the client, i.e. the asset owner. It is therefore important that 'the ball is in the court of the asset owner', which must clearly assign the task of meeting its engagement objectives to the asset manager. It is then up to the asset manager to properly translate this assignment into engagement activities and to report on the results, so that the asset owner can adjust the assignment if necessary.

The interviews revealed a widely shared expectation that asset managers' implementation of engagement in the future will increasingly follow from the specific contractual relationship with the client. Whether and how engagement is used will follow from the client's specific investment goals. Engagement can only be used for those clients where it is relevant, so there is no one size fits all.[3] This specific interpretation means that the engagement also falls within the asset manager's fiduciary responsibility. Furthermore, the increasing concentration (and cost pressure) in the asset management sector may make this tailor-made approach more complex. After all, consolidation means a larger and more diverse investment audience that needs to be catered for, with a correspondingly wider diversity of ESG preferences.

3.2 Large shareholding in the company creates legitimacy

The larger the equity stake that an asset manager has in a company, the greater is its legitimacy and the greater the chance that the company can be encouraged to change course through engagement. It also helps if the asset manager has a credible reputation and track record – in the form of previously successful engagements – to be able to challenge the company (Marti et al., 2024). With a small equity stake, it is difficult for investors to get a serious seat at the table and it makes more sense to seek partnerships with other investors – see also Bosma et al. (2022); Koedijk et al. (2020) and Kölbel et al. (2019).

A possible risk of this 'scale criterion' is that it can lead to the wrong incentives. Since engagement is more effective when the invested capital in a company is larger, the engagement efforts may focus mainly on the companies in which the asset manager has a large interest. However, these will not necessarily be the companies that are most relevant and that require most attention from a social and sustainability perspective (Balp et al., 2023).

3 A similar trend can also be seen amongst US asset managers. For example, Vanguard has announced that it will offer its clients several options regarding how Vanguard should vote at the Annual General Meeting (AGM) of companies in which they invest: a) profit above ESG, b) ESG priority or c) at Vanguard's discretion.

3.3 Professional engagement process requires sufficient capacity and resources

A widely recognised success factor concerns the asset manager's establishment of a professional engagement process with sufficient capacity, resources and patience to structurally drive ESG themes. Engagement must be embedded in a professional, formalised process. This includes asset managers having significant capacity, resources and strategic space and being willing to use them. Moreover, patience is required, since implementing changes to improve ESG performance is inherently a longer-term process (Brière et al., 2024; Dimson et al., 2015). In general, the more intensive the contact with the company during the engagement, the greater will be the chance of success (Bauer et al., 2022).

It is also important that engagement is consistent with other parts of the asset manager's sustainable investment policy and that it speaks with a single voice. The credibility of engagement depends to a large extent on how consistent it is with choices in the investment universe (selection/exclusion) and particularly with the exercise of voting rights at shareholders' meetings. An integrated engagement approach that includes portfolio managers and the engagement team is also helpful in ensuring that the asset manager always speaks with a single voice to the company.

3.4 Knowledge of the company's business model and ESG expertise is needed

A frequently cited success factor is the asset manager's ability to contribute deep knowledge and expertise to the dialogue. This includes on the one hand knowledge and expertise concerning the company and in particular its business model and on the other hand knowledge and expertise concerning the ESG themes on which the engagement is based. The asset manager must understand the company's business model, as well as the impact of the sustainability transition on it. In doing so, it must be able to properly assess where the company is positioned in relation to its peers and what steps are needed to develop further ('know what you own'). This makes the asset manager a serious discussion partner for the company.

3.5 Coordinated cooperation can increase effectiveness

Since individual asset managers often have a modest equity stake in a company, it may be helpful to enter into partnerships with other asset managers in order to exert joint influence. This coordinated collaboration between asset managers can make engagement more effective (Barko et al., 2022; Bauer et al., 2022; Brière et al., 2024; Derwall et al., 2022; Dimson et al., 2015 and 2023). At the same time, some literature questions the effectiveness of collective engagement (see, amongst others, Hastreiter, 2024).

Although several variants of cooperation are conceivable, a common form is a jointly financed asset management partnership with a rotating lead investor who takes the lead in engagement. There is evidence that these lead investors, provided they also have a significant stake in the company, often also play an important role in improving the company's ESG performance (Ceccarelli et al., 2021). The chance of success of engagement seems to be increased if this lead investor shares many geographical, linguistic and socio-cultural similarities with the engaged company. It also helps if participating foreign asset managers come from countries with strong ESG standards (Dimson et al., 2023; Bosma et al., 2022; Marti et al., 2024). Other preconditions for effective coalitions according to the literature are that they are not too large (no more than 25 participating parties seems to be the most effective), that they have various degrees of experience in the ESG field, that they are adequately financed, that the participating parties have equal interests and incentives (trust is crucial) and that a cooperation horizon has been established (e.g. a maximum of seven years). Of course, such partnerships also face challenges, such as free rider problems and the time and cost associated with coordination and harmonisation.

The interviewed asset managers say they participate actively in these 'collaborative engagements'. The advantages of this are generally considered to outweigh the disadvantages. Participation is generally not very costly and it seems relatively easy to agree on the thematic objective of the engagement effort. Another important advantage of cooperation is the exchange of knowledge and expertise and the creation of greater leverage towards the company, which helps make the engagement more effective.

We nevertheless note that global engagement coalitions such as Climate Action 100+ are under pressure. Some large American asset managers announced last year that they would leave this coalition or scale down their participation. Although the reasons were not very explicit, they did mention 'prioritising their own engagement policies over participation in joint policy. Their departure is also consistent with the generally critical sentiment towards ESG in the US.

3.6 Requested reforms are targeted and achievable

From a practical perspective, engagement is found to have a better chance of success if the requested reforms are targeted and feasible. It is important that the requested measures and reforms are in line with the company's value creation and business model. There is no point in making unrealistic demands. In practice, the focus is on incremental adjustments that are (commercially) feasible, that support the change process that companies go through and thus gradually contribute to real-world impact. Examples include disclosures on a specific ESG theme, adjustments to a company's governance or the development of policy.

A criticism that can be made here is that the focus on measures that are relatively easy for the company to implement ('low-hanging fruit') can distort the effectiveness of the engagement instrument. After all, engagement then seems to be relatively successful, while such reforms, as indicated earlier, have limited direct impact in terms of reducing the company's actual ecological and social footprint. Moreover, these may be measures that the company would have taken even without engagement. As soon as engagement requires costlier material reforms that affect the company's business and revenue model, for example, and can therefore potentially be more impactful, it seems to be a less effective instrument (see also Diaz-Rainey et al., 2023; Barko et al., 2022; Kölbel et al., 2019; Heeb, 2024).

Another objection concerns the risk of 'backloading'. By focusing on targeted and achievable reforms, engagement can contribute to greater policy ambitions and commitments on the part the company. This includes the setting of medium- and long-term objectives by the company, such as a net zero commitment for CO_2 reduction. This may bring the unintended risk that companies will shift the actual reduction of CO_2 emissions backwards – known as backloading (see also Hastreiter, 2024).

3.7 Quality of engagement activities must prevail over quantity

Asset managers are increasingly trying to bring focus to their engagement, so that quality takes precedence over quantity. According to the interviewed asset managers, focus is needed to create real added value with engagement. Only then can an asset manager truly understand a company's business model, strategy and ESG challenges, build up knowledge and expertise and act as a fully-fledged sparring partner for the board. And only then can the intensity of engagement be increased. By way of illustration, a very intensive engagement process can require as many as 23 actions in a year. Against this background, sending a mere letter to a series of companies in the investment portfolio and not following up on it is not considered very effective.

This means that in practice a conscious choice is increasingly being made to limit engagement efforts to a fairly select group of companies and to focus on a limited number of specific ESG themes. It is important to ensure consistency here by adhering to chosen ESG engagement themes over a longer period of time. It helps if the ESG themes in question are embedded in broader social trends. Reforms requested by shareholders can then be embedded and related to societal feelings of justice or injustice (Marti et al., 2024), increasing the chances of success of the engagement

However, this intended focus is not always clear from asset managers' engagement reports. The number of companies engaged in a year and the number of engagement activities carried out annually seems to have been considerable over the past few years. A survey of asset managers in the UK that endorse the FRC's UK Stewardship Code shows a similar picture (Redington, 2023). At the same time, this is difficult to assess unambiguously because the definitions used of, for example, engagement activities are often unclear and may also differ greatly between asset managers.

3.8 A credible threat of escalation is essential

The impact of engagement can be magnified if it is accompanied by a credible threat of escalation (Heeb, 2024). To this end, the asset manager has a range of potential actions at its disposal, the ultimate measure being exclusion of the company from the investment portfolio (Bosma et al., 2022).

At the same time, especially in the case of larger listed companies, most interviewees believe the threat of exclusion in the event of unsuccessful engagement only acts to a limited extent as a real 'stick'. The overall view is that the exit of an institutional investor mainly causes short-term reputational damage to the company concerned. In the long term, however, the impact of exclusion is generally considered to be relatively limited: as long as there is still sufficient demand for the share and therefore other investors will step in, the impact on the company's cost of capital is limited (see also AFM, 2022). More benefit is often seen in influencing the composition of the board by voting on appointments or reappointments at the Annual General Meeting (AGM), or submitting shareholder resolutions. Such instruments are given more weight to bring about long-term changes in the ESG field. Nevertheless, asset managers are sometimes forced to reduce investments in companies and add them to their exclusion list if the above escalation measures still fail to make sufficient progress.

In this context, it remains to be seen whether the increase in passive investing will be an obstacle to engagement (Box 3.1).

Another observation is that engagement on asset classes other than shares in listed companies may be more promising. This could include private equity or debt financing because there is greater scope for leverage on the company; in the case of private equity, the relationship with management is much more direct and obstacles to debt refinancing may cause more 'real pain'.

Box 3.1: Influence of passive investing on engagement effectiveness

The fact that exclusion cannot be used as the ultimate escalation in passive investing (since the asset manager tracks an index) does not appear to be seen as a major shortcoming, as stated earlier. Mention is also often made of the fact that asset managers with passive funds by definition enter into a long-term investment relationship with companies and that as passive investors they can of course also vote at the AGM. Also, in order to limit the comparative disadvantage of inactive trading of passively managed funds compared to active investment funds, engagement could actually be a way to improve the governance and financial performance of the companies in the portfolio. Moreover, an active engagement strategy can be seen as a useful branding tool to attract and retain retail investors (see, amongst others, Balp et al., 2023).

At the same time, there are also reservations about the rise of passive investing in relation to engagement. Passive fund providers are focused on low fees. However, engagement – especially with a large group of companies in the portfolio – is costly and managers of passive funds may want to minimise their engagement efforts. This could therefore lead to free-riding behaviour, with asset managers no longer engaging themselves but relying on the engagement activities of other investors in a company (see also Derwall et al., 2022; Balp et al., 2023). This is exacerbated by the fact that passive investment funds are managed in an increasingly concentrated market, with a significant proportion of the global assets in index funds now being managed by the top three asset managers in the US. In the US, it is already clear that the large asset managers are coming under political pressure due to their size, which apparently makes them reluctant to exercise their shareholder rights in the ESG area. Some academics do not rule out a similar development in Europe in the long term (see, amongst others, Boot, 2023).

3.9 Strengthening engagement by using leverage

The interviewed asset managers indicate that field building is becoming increasingly important for them as a tool to increase the effectiveness of their engagement. In addition to influencing these stakeholders, conversations with third parties also help to hear a different perspective than that of the company. It also enables asset managers to maintain a better view of which ESG themes are becoming important and of the development of regulation.

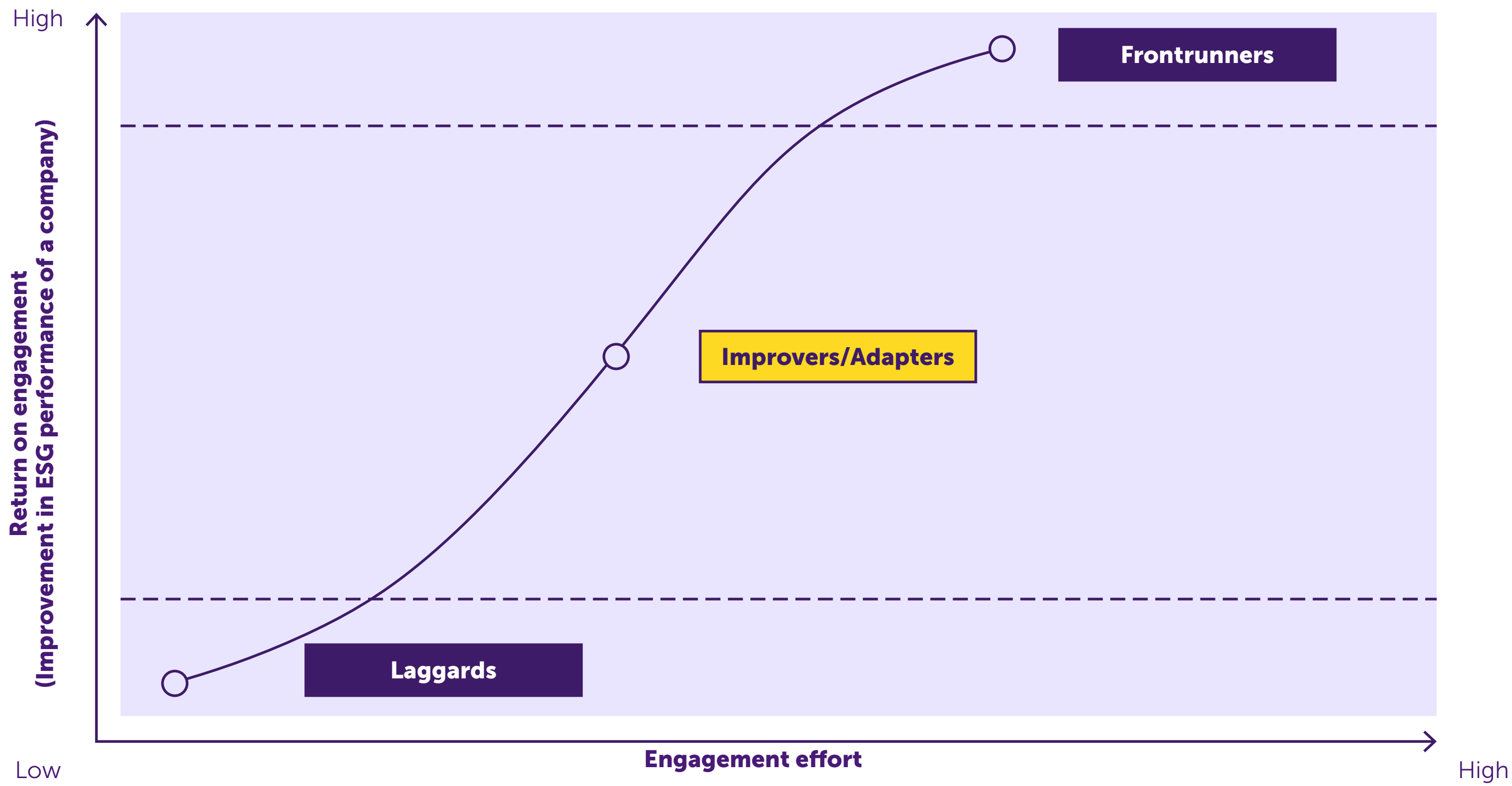
3.10 The company is open to engagement

The interviews show that asset managers focus their engagement programmes to a large extent on companies that are 'open' to engagement. These are companies that recognise that they need to make the sustainability transition and are therefore open to engagement (the 'improvers/adapters' category in Figure 3.2). Engagement logically has a greater chance of success if the companies in question are ESG-sensitive and are already making some progress in the areas of diversity, the working environment or climate policy, for example. Conversely, there is a lot of literature that indicates that companies with a poor ESG track record are less likely to be willing to adjust their behaviour (Barko et al., 2022; Diaz-Rainey et al., 2023; Dimson et al., 2015; Kölbel et al., 2019; Wagemans et al., 2018; Marti et al., 2024). Engagement is a costly activity and in that sense there is something to be said for the fact that the focus is primarily on parties that are also receptive to it. A company must be 'engageable' to some extent in order to achieve something. It is also notable that in practice asset managers seem to focus on laggards in the portfolio, sometimes simply because the company is in danger of not (or no longer) meeting the requirements to remain in the investment portfolio.

At the same time, a frequent criticism is that the selection of companies for engagement is therefore not exogenous. Since asset managers select companies where engagement is considered to have a good (or better) chance of success, it is possible that these companies would in any event already take the measures pursued through engagement. This selection bias may overestimate the effectiveness of engagement.

As engagement is focused on companies and activities that are on their way to being 'green', it can contribute to transition financing. Within the spectrum of ESG finance, transition finance – financing companies that are in the process of transitioning from 'brown' to 'green' – is becoming an increasingly important category. Engagement is an important tool for investors to give substance to this (Sustainalytics, 2024). In order to be able to select promising companies from a transition perspective, it is important that these companies can be properly identified and that their progress is monitored. High-quality transition plans – plans in which companies set out their sustainability goals and how they intend to achieve them – are instrumental in this (Van Geest et al., 2023). Transparency regulations such as the CSRD, but also sector initiatives such as the Transition Pathway Initiative, aim to contribute to a better quality and comparability of transition plans.

Figure 3.2: Most asset managers focus their engagement mainly on the 'improvers'



Laggards

The company shows no intrinsic conviction or willingness to change. It denies the importance of the sustainability transition. The return on engagement for such companies seems low. In any event, such companies may already fall outside the asset manager's investment universe.

Improvers/Adapters

The company recognises the need to make the sustainability transition. The company shows (some form of) intrinsic willingness and has the capacity to implement necessary changes. For this group of companies, the ESG return on engagement seems the highest and engagement therefore the most promising.

Frontrunners

The company is already far advanced in the sustainability transition. It is questionable whether the asset manager can take this company much further by means of engagement. The ESG return may be low, given the required engagement efforts.

Source: AFM

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