RESEARCH SPOTLIGHT

Q4 2020 BOARD & PAY

2020 was a critical year for the development and acceptance of ESG investing, and a year that brought new recognition to ESG factors in the minds of investors and consumers.[1] With the onset of COVID-19, S pillar issues around the gig economy, sick pay, and paid leave policies quickly gained the spotlight, and we discussed these developments in our Q2 2020 Research Spotlight.

Despite the rise in S pillar recognition, the "E in ESG" has been competing to attract stakeholder and media attention, and has been a significant focus of emerging regulation. The European Green Deal, the sustainable activities Taxonomy regulation, and the Sustainable Finance Disclosure Regulation, among other initiatives, have demonstrated the "green" focus on environmental issues from the EU regulatory perspective which have become a major focus for investors. Meanwhile, investor perspectives on climate issues have evolved from a narrow focus on carbon emissions to a broader understanding of climate related risks and opportunities, which we reviewed in our Q3 2020 Research Spotlight.

It is clear that the "E" and "S" in ESG have received significant attention in 2020, and at times appear to dominate the headlines when ESG is discussed. Despite the recent attention given to E and S issues, we feel it is important to recognise and revisit the critical role that Governance plays in ESG investing. In this Research Spotlight, we discuss the role of Governance in our investment process, as well as our stewardship and engagement activities.

The Importance of "G" in ESG Investing The importance of good corporate governance has a rich history in the literature, and contemporary research only underlines its significance and materiality. A recent 2020 paper by MSCI concluded that Governance was more significant than the E and S pillars in terms of impact on profitability, idiosyncratic risk and systematic risk over a short-term horizon. Specifically, "the results suggest that financial markets largely focused on events that could immediately affect company valuations" and that Governance pillar incidents, such as ethics breaches and fraud, impacted stock prices more quickly than E or S issues or controversies. In contrast, while some S and E issues, such as accidents, strikes, or oil spills do pose "event" risks, more frequently S or E issues presented "erosion" risks, and degraded financial performance over a longer time horizon. [2 3]

A now-famous 2015 meta-study by Friede, Busch, and Bassen, which combined the findings of about 2200 individual studies, found that not only is "the business case for ESG investing empirically very well founded" across E, S and G pillars, but also when examining sub-effects in each category that G had the highest proportion of positive relation with corporate financial performance in the metastudy.[4] The case for the materiality of Governance factors is well established.

There are many aspects to assessing corporate Governance quality and standards. Below, we discuss two major themes within Governance that are relevant both to our investment process and decision making, but also to our own stewardship and engagement activities: board composition and executive pay policies.

BOARD DIVERSITY

The 2018 UK Corporate Governance Code notes that both appointments and succession plans should "promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths".[5] Furthermore, there is a general consensus in our research review that groups of greater diversity are better problem solvers, and that while homogenous groups feel more confident about their decisions than diverse groups, they often make poor decisions compared to those of diverse groups. [6 7 8]

The literature increasingly suggests companies with female leadership can lead to strong performance; a recent study found a Return on Equity of 10.1% per year for companies with significant female leadership versus 7.4% for those without, and superior average valuation compared to companies without strong female leadership. Other research finds that companies lacking board diversity suffered 24% more governance-related controversies than average.[9]

Academic research also suggests that three women may constitute a critical mass on corporate boards to allow women to contribute more equally to group decision making;[11] increasing the number of women to three or more enhances the likelihood that women's voices and ideas are heard and that boardroom dynamics change substantially.

Given the strong evidence for better board performance and the social and economic value of board diversity for all stakeholders, our ESG security selection process includes measures of gender diversity at senior management and board levels as part of G pillar evaluation. *The graphic to the side highlights some gender diversity metrics used, and how our long and short portfolios measure up, as of 31 Dec 2020.*

How ECO Advisors Promotes Diversity

As part of our stewardship and engagement activities, our voting decisions are informed by an in-house board diversity voting policy. For each board member nomination or re-nomination, we examine the current diversity of a company's board and set specific board diversity thresholds necessary prior to voting in favour of board nominations. The appropriate thresholds have been decided through a combination of careful assessment of evidence and consideration for appropriateness for the relevant market.[11]

We also believe that engagement on ESG matters with investee companies is most effectively carried out in collaboration with other like-minded investors. We believe that ESG driven corporate engagement and voting can increase the ability of firms to create long term shareholder value, and as such, engagement is a core part of how we manage the Fund. Among several other collaborative initiatives, ECO Advisors is a member of the 30% Club Investor Group, a collective of asset owners and asset managers committed to exercising our ownership rights, including voting and investor statements, in order to effect change and to engage on the issue of diversity with company boards and senior management teams.

EXECUTIVE PAY

Will COVID-19 Bring Executive Pay Back to the Spotlight? The COVID-19 pandemic may also lead to increased shareholder scrutiny of executive pay practices, though shareholders seemed to give management a "pass" in 2020. While pressure from shareholders in 2020 led some executives to take temporary pay cuts, many reverted to full pay by summer. In fact, one consultancy found that companies in Spain, Italy, the Netherlands and the UK were more likely to cut dividends than executive pay in 2020. Some proxy voting experts predict that, due to the pandemic, shareholder attention on executive pay is likely to increase next year.[12]

Aligning Executive Pay the Right Way There is general consensus in the academic literature that executive pay should be linked to performance in a way that encourages long-term decision making. The literature suggests that the best measure of executive performance currently available is the long-term stock performance, which "captures almost all actions that affect firm value, including those impacting stakeholders, and weights them according to their materiality".[13]

Research suggests that the best way to ensure senior executives are aligned with long-term performance is to offer lower fixed compensation, such as salary, which they receive irrespective of performance, in conjunction with greater deferred compensation, such as restricted shares.[14] [15] The value of these shares is automatically sensitive to performance, and reflects the long term future prospects for the firm, which short-term accounting based targets do not. Furthermore, there is evidence that stock markets respond positively to the adoption of long-term incentive programs for senior executives.[16]

One study by von Lilienfeld-Toal and Stefan Ruenzi studied the relationship between CEO voluntary stock ownership and long-term stock returns over a twenty-three-year period. Firms with large CEO stakes "beat those with small stakes by 4% to 10% per year".[17]They also enjoyed higher return on assets, labour productivity, cost efficiency and investment. In another study, from 1970 through 1988, the average annual compound stock return on the 25 companies with the 'best' CEO incentives, defined as "controlling a meaningful percentage of total corporate equity", was 14.5%, more than one-third higher than the average return on the 25 companies with the 'worst' CEO incentives.[18]

ECO Advisors Voting and Executive Pay Practices

In addition to our board diversity policy, we have implemented criteria to guide our voting on executive pay. We believe that the goal of executive pay should be to incentivise leaders to create long-run value for all stakeholders; pay should reward value creation that can be shared by both shareholders and other stakeholders. Data points include long-term CEO incentives that promote stakeholder value rather than short-term incentives, whether the CEO's equity pay reflects the company's total shareholder return performance, whether pay figures fall into an extreme range relative to peers, and if there appear to be abnormally large bonus payouts without justifiable performance linkage or proper disclosure.

While ESG investors may expect their managers to align their stewardship and proxy voting in accordance with their ESG mandate, in practice funds may not always focus on promoting an ESG agenda through their voting and engagement. In fact, a study by MIT Sloan's Gita Rao published in December 2020 reveals that several prominent ESG funds have a long history of voting against resolutions promoting gender diversity and other ESG issues, and demonstrate a lack of transparency in their engagement process.[19] **We believe that a diligent and transparent approach to stewardship, voting and engagement is a key element of responsible investment management in accordance with our ESG mandate.**

REFERENCE FOOTNOTES

[1] https://www.forbes.com/sites/chukaumunna/2020/12/18/esg-investing-came-of-age-in-2020millennials-will-continue-to-drive-it-in-2021/

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[4] Friede, Gunnar, et al. "ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies." *Journal of Sustainable Finance & Investment*, vol. 5, no. 4, 2015

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[9] https://www.msci.com/documents/10199/04b6f646-d638-4878-9c61-4eb91748a82b

[10] Kramer, V. W., Konrad, A. M., and Erkut, S. "Critical Mass on Corporate Boards: Why Three or More Women Enhance Governance."

[11] The full criteria and voting guidance is available in our voting policy which is available upon request.

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