Board engagement and climate change take center stage

**Key Points**
- Board engagement is increasingly important to our investment stewardship and environmental, social, and governance (ESG) research process.
- We expect our research and engagement on the physical risks of climate change to be integral to many more conversations in 2020.
- Emerging regulations related to shareholder rights, human rights, and audit quality are also on our radar.

In 2020, we will focus on several ongoing topics, including board engagement, climate research, and emerging areas of regulatory interest.

**Board engagement**

We believe direct engagement with corporate boards can enhance discussions about long-term material ESG issues, complement our ongoing conversations with management teams, and help us assess a board’s effectiveness — which is challenging to do using company disclosures alone. We seek to understand how a board collaborates with management and delineates responsibilities. We look for indications that directors foster healthy debate, develop constructive relationships with management, and challenge the team where appropriate. Where we see opportunities for improvement, we provide feedback and explain how the suggestions can benefit our clients, their ultimate stock or bondholders. We expect to have more engagements with late-stage private companies to help them bolster ESG practices, potentially avoiding costly missteps during the IPO process.

We continue to take a multidisciplinary approach, including perspectives from equity and fixed income analysts for a richer dialogue. In 2019, board engagements comprised about a third of our ESG-focused discussions, and we expect that ratio to rise in 2020. As more directors become accustomed to these interactions, we expect board engagement to remain central to our investment stewardship and ESG research process.

**Climate change**

Climate change is also a key area of focus for 2020. Since we began engaging with portfolio companies to encourage adoption of the Task Force on Climate-related Financial Disclosures (TCFD) reporting framework three years ago, we have been encouraged to see many companies improving their disclosures. We have observed that attention remains focused on climate transition risks, leaving a reporting gap in investors’ understanding of companies’ resilience to physical climate risks.

Building on our work with the Woods Hole Research Center studying how and where climate change may impact capital markets, we recently collaborated with the California Public Employees’ Retirement System (CalPERS) to create a new Physical Risks of Climate Change (P-ROCC) framework. We intend for this guide to help management teams integrate climate science-based scenarios into their strategic planning and disclosures. Please see a detailed summary and link to the framework at the end of this chapter.
The connection between our climate research and company engagement is direct. Our work with Woods Hole and CalPERS helps us raise awareness with management teams regarding the science and their vulnerabilities. Our proactive work may provide the impetus to invest in their own resilience efforts, as we’ll have the evidence they may need to justify those investments.

**Emerging regulations**
Several newer regulations will influence our ESG research and stewardship efforts.

**Shareholder rights in the US**
In 2020, we will continue to monitor recently proposed rules by the US Securities and Exchange Commission (SEC) affecting proxy advisory firms and shareholder proposals. As stewards of our clients’ capital, we strongly support shareholder rights and believe the new procedural requirements around shareholder proposals may unnecessarily burden shareholders who wish to exercise those rights. As a client of proxy advisory firms, we rely on their timely, high-quality, independent research to inform our own work and proxy votes on behalf of our clients. The proposed requirements around registrant prereview and expanded anti-fraud risk may negatively impact the timeliness and independence of proxy advisor research. We will be analyzing the proposed rules closely to ensure we understand their potential impact on stewardship. Along with many industry counterparts, we have requested a longer comment period, and as we complete this analysis, we expect to assess how to most effectively share our views with the regulator.

**Human rights**
Following the 2015 passage of the UK’s Modern Slavery Act, a handful of countries have passed laws requiring companies to report on how they are addressing risks related to human rights abuses in their global supply chains. Starting in late 2020, Australia’s newest regulation will also require asset owners to report on these risks in their investment portfolios. While human rights have been a part of our research and engagement in this context, our goal is to formalize a framework for assessing companies’ exposures to these risks, determine the sectors for which these risks are most material (highest possibility of supply-chain exposure), enhance our own engagement questions, and potentially work with external data providers to gain insights on specific companies or industries.

**Audit quality and oversight**
Scrutiny of auditors, particularly audit quality and oversight, has been increasing. The Big Four global audit firms currently control the market but face minimal regulation. In the UK, recent corporate audit failures have increased regulatory pressures, leading to proposed rules such as mandating joint audits and operational splits. While scrutiny in the US is less intense and regulation is less likely in the near term, in our view, regulatory boards, including the SEC and Public Company Accounting Oversight Board (PCAOB) are becoming more active. In 2020, we expect to dig deeper into companies’ audit processes to better understand the potential risks. Some considerations on our radar: How can we gain more insight into how company audits are conducted and learn more through our ongoing engagements with board directors? How will the UK’s new Audit, Reporting and Governance Authority impact the audit practices of our portfolio companies in this market? How can we use our engagements to encourage integrity of the audit process and board oversight most effectively?
ESG & SUSTAINABILITY — COMMODITIES

Commodities through the lens of sustainability

KEY POINTS
- We believe environmental, social, and governance (ESG) and sustainability considerations can create constructive market conditions for commodity fundamentals.
- Within the energy sector, climate change concerns and the move to decarbonize are discouraging capital spending on conventional oil projects.
- Industrial metals will likely experience secular tailwinds from rising demand for battery technology and the electrification of the power grid.
- Agriculture could see a rising risk of production shortfalls due to drought, heat, and acreage migration.

AT THE START OF A FRESH DECADE, we remain focused on fundamentals and other developments that could meaningfully affect commodities in coming years. To that end, we believe viewing the asset class with a sustainability lens offers a differentiated, critical perspective. It is perhaps counterintuitive that ESG and sustainability considerations can be constructive for commodity fundamentals.

Energy
While energy fundamentals have been attractive recently, production from several non-OPEC, ex-US oil projects coming online in 2020 will likely cause already challenging fundamentals to deteriorate further. These projects, which have taken years to ramp up, were approved during an era of much higher oil prices earlier in the decade. Since then, capital spending has been severely rationalized. While this production is expected to push the oil market into near-term surplus, signs that US shale production is starting to decline could limit the amount of oversupply. Looking farther out, we also see many reasons for optimism, thanks to greater focus on sustained capital discipline.

In the US, oil production growth may have peaked as a result of the slowing shale output and intensifying investor engagement around capital discipline, which has essentially closed some markets to producers. Looking at the global energy landscape, we see evidence of similar restraint; however, this is more likely the result of climate-related considerations. Investor skepticism and debate around the secular demand for oil amid the movement toward decarbonization — and the growing demand for electric vehicles — is also bullish for the sector, in our view. Cautious sentiment and environmental considerations have created a very high return hurdle for capital spending on conventional oil projects among the large integrated companies. This squeeze has the potential to support oil markets through inadequate supply additions for the next 10 years, even in a lower demand-growth environment.

Industrial metals
Much of the last decade was spent working through elevated metals inventories, which, combined with capital restraint from producers, has resulted in supply tightness across the complex. More recently, falling global demand has shrunk some supply deficits, although the lack of capital spending continues to paint a favorable fundamental picture for the sector.
Base metals such as nickel and copper are key components of battery technology and the electrification of the power grid. These metals are seeing a structural demand boost as a result of those themes. Both copper and nickel production projects carry very long lead times, and the recent years’ under-investment indicates supply shortfalls over the coming decade.

Recognizing the importance of commodity exchanges, we consider the London Metals Exchange’s (LME’s) October 2019 announcement of a framework for responsible sourcing requirements to be significant. The framework aims to improve transparency around the source of origin for metals delivered against LME contracts. Over time, this approach could further tighten metals markets as commodity investors increasingly reject exposure to supplies sourced from unattractive jurisdictions.

**Agriculture**

While agriculture fundamentals are looser than energy or metals for 2020, longer term, our climate research points to a rising risk of production shortfalls. The risks of drought, heat, and acreage migration (geographical shifting of viable planting land) are rising. At the same time, the global population is expected to double in the next 20 years, driving long-term demand growth and stretching supplies further.

We view climate change as one of the principal drivers of a secular reversal of the last 100 years of agricultural productivity gains. Many regions could experience an increase in the number and magnitude of damaging climate-related weather events, which likely will increase the frequency of supply shocks. As in 2012, when many important agricultural markets were hit hard by adverse conditions, these events can severely disrupt stocks across the complex. Greater volatility and tighter supply balances would be supportive of higher prices going forward.

Overall, recognizing the potential effects of sustainability considerations on commodity markets, we believe investors should sharpen their focus on issues like climate change and sustainability. In many ways, the global shift toward a sustainable future, while challenging in the near term, could be broadly supportive for the energy, metals, and agricultural sectors.
Actionable ideas

Why the market gets sustainable investing wrong
Sustainable investing has a number of market inefficiencies, making it a compellingly mispriced market segment, in our view. Currently, five key inefficiencies offer active managers ample opportunities to potentially generate alpha:

- The market’s focus on short-term growth
- Inconsistent, backward-looking ESG ratings
- Emerging market indices’ underexposure to structural development
- Blind spots in climate risk analysis
- An undefined impact investing universe

Learn more: Why the market gets sustainable investing wrong

Pricing climate risk: A multidisciplinary approach
Like most secular trends, climate change presents significant opportunities and risks for investors, but so far, even asset owners with long-lived liabilities have largely failed to incorporate it into their portfolio management and capital allocation considerations. As active managers and fiduciaries, we consider it our responsibility to help protect and grow our clients’ assets. Working toward solutions that enable us to accurately price assets is a big part of that. We believe multidisciplinary research enhances our ability to get climate-related asset repricing right.

Learn more: Pricing climate risk: A multidisciplinary approach

Physical Risks of Climate Change (P-ROCC)
Partnering with the California Public Employees’ Retirement System (CalPERS), we’ve created a framework to help companies assess and disclose the potential effects of the physical risks of climate change on their businesses. This guide aims to facilitate more informed investment decisions through enhanced corporate disclosures. In the guide, we highlight and provide details on developing climate scenarios, working with climate experts, and building executive and board knowledge.

Learn more: Physical Risks of Climate Change (P-ROCC)
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