THE PRINCIPLES FOR RESPONSIBLE INVESTMENT PODCAST TRANSCRIPT

THE ROLE OF STEWARDSHIP: REFLECTION FROM PROXY SEASON 2022

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BONNIE GROVES

Welcome to the PRI podcast. My name is Bonnie Groves and I’m a Senior analyst and the stewardship team at the PRI in this podcast, we will be talking about highlights and trends in this year’s proxy season, the time where most companies hold their annual general meetings. At the PRI, I managed a resolution database. This is a database of ESG related resolutions and votes.

One resolution that caught my attention was on the processing of payments for ghost guns. Ghost guns are homemade firearms without any formal serial number to trace them within the context of gun crime in the US and elsewhere, this is clearly a serious topic. But I hadn’t expected it to appear at the annual general meeting of a bank. It gave me a good reminder of the breadth and depth of topics that investors need to be aware of and the range of avenues that investors have to raise these
issues to give some colour and context to proxies in 2022, and to discuss the important role of investors. I'm pleased to be joined by John Hoeppner, Head of US stewardship and sustainable investments at legal and general investment management America and Aeisha Mastagni portfolio manager for sustainable investment in stewardship strategies at California state teachers, retirement system investments. So Aiesha and John, thank you for joining me today and welcome to PRI podcast.

AEISHA MASTAGNI
Hello Bonnie, thank you so much for having me.

JOHN HOEPPNER
Thanks Bonnie.

BONNIE GROVES
Before we jump into the challenges of 21st century politics and what investors can be doing, I'd like to set the scene. Stewardship is in all our job titles, but Aeisha can you explain a little what we mean by this?

AEISHA MASTAGNI
Sure. The classic definition of stewardship is the management or care of something for CalSTRS We strive to be good stewards of the capital and trusted to us because our mission is to provide a safe and secure retirement for the teachers of California. We're very long-term investors and we are universal owners, meaning that we own the entire market. So, we use our stewardship activities as a way to add value and mitigate risk, as part of our portfolio management. This includes everything from proxy voting engagement with our portfolio companies and influencing the regulators and policy makers.

BONNIE GROVES
And John, we've seen a lot more stewardship in the last few years. Why has it come into spotlight so much?

JOHN HOEPPNER
There are three main reasons. One is the rise of index investing. The second is alignment between investors and the long-term interests of the underlying participants. And the third is the perception that it’s actually effective. Let me give you an example of each one. The rise of index investing has actually been a profound shift over the past. At least 10 years report came out last month that the majority of US stock is actually owned by index-based managers rather than active managers. That
means that there's a concentration in the number of managers that different index managers are competing to offer different services. And so it really has shifted market dynamics. It also means that we're all diversified as Aeisha mentioned. The second thing is this alignment as asset managers, we get paid on the amount of assets that we manage. We're completely aligned that there isn't big shifts in value.

JOHN HOEPPNER

So if we see climate risk as a really big risk, then we want to start to reduce that risk almost at a systems level, not by one by one company, but really across the board. And the last I mentioned is this perception of effectiveness. A lot of folks are really frustrated with political and action, or let's say the pace of change they're seeing across many different companies. And they've actually noticed that as an investor, you get an outsized voice on important topics. It could be reproductive health, it could be gun laws, it could be climate disclosure. We've seen 1600 companies disclose via the task force for climate change, financial disclosures. That is all voluntary, but it's a signal that actual, you know, market driven efforts can actually produce results.

BONNIE GROVES

Right? So we're talking about a range of activities and we're talking about systemic risks. This isn't easy. How do you both work to untangle and tackle the challenges that surely come up?

AEISHA MASTAGNI

I can jump in here. John brought up sort of these systemic risks to our portfolio. And I think it's important to recognize that there's lots of activities. And so we try to tackle this on two fronts, one at a regulator level or system level, like for example, with the securities and exchange commission, working to influence them to ensure we have the right disclosures that we need as investors to manage these risks. And then we do, you know, systematically go one by one, in terms of the companies in which we engage. Particularly, we look at companies where we feel that there's either the largest value to be had or because it's a risk that might affect more than one company in our portfolio.

JOHN HOEPPNER

One of the biggest challenge I mentioned right upfront is the perceived effectiveness. What I really mean by that is it's really hard to measure what is successful stewardship and what is the purpose of stewardship for us? We spend an inordinate amount of time measuring all of our individual activities. Just because a shareholder resolution made it through the legal process, doesn't mean we had the impact we were looking for. For sure we'll get market attention or the media might write a story about it, but did the underlying issue change? I mentioned we have 1600 companies now doing
climate disclosure, but our total carbon emissions at a planetary level are still going up. You have to be very sceptical on is all the noise actually creating the change that you're seeking.

BONNIE GROVES
So then in the frame of these really complex issues, of course we are still seeing resolutions being filed. This is one way to tackle a challenge. Can you comment on that?

JOHN HOEPPNER
Sure. I, I think a useful tool that I would suggest for investors is to study what I think of as the edge cases. So new resolutions where the market is split. So there are really different views in the market. This year, there were four US banks where there were shareholder resolutions seeking to have policies, setting the bank lending to be aligned with a Paris aligned world. And the support was mixed roughly 20% across those four banks. We supported those resolutions because we saw the underlying companies had made similar commitments. And so we didn't view this particular proposal as micromanaging their individual business. Many of our peers didn't support those, but we don't always support these right. There was another resolution, very similar in Australian banks, Westpac in particular, they had actual specific views on business lines and we thought that was going too far. So that's just an example for legal in general, on how we're really trying to study the issues and follow as things are evolving. One tool that investors can use is where there's differences in the market. You know, real kind of a 50 /50 split.

AEISHA MASTAGNI
Just as a follow up to what John was saying about those proposals at the banks, CalSTRS, after a very intense internal debate, we decided not to support those proposals. It was really based on a couple things. We did feel like the proposals were stepping a little too far into what we would consider operational management of a company. We really feel like our job as investors is to ensure we have the right people inside the boardroom that can oversee the operations of a company. And if we think that those individuals are failing on our behalf, then we have a responsibility to not support them at the next election.

BONNIE GROVES
Just picking up on your mentioning of who's in the boardroom last year, we saw one of the key moments of proxy season that was really picked up on is a highlight, was the success of the engine number one campaign at Exxon. Before we go on to comment on that, could you Aeisha just expand a little on what that was?

AEISHA MASTAGNI
Sure. So the campaign at Exxon was really a proxy contest or what you would call a contested election. There were more directors up than available seats inside the boardroom at Exxon. And we decided to embark on this campaign because all of our other avenues for affecting change really had failed. The previous year, we had voted against the entire board because we thought that they had failed in their duties to really help this company transition. There had been shareholder proposals that we had supported that had passed by a majority vote and the company all but ignored them. And last but not least, you know, collaborative engagements that we work on, for example, climate action 100 had failed to yield the same results they had gotten at other companies or the same types of commitments from other companies in terms of reducing emissions. When you start to break down how that board was structured, they were all very accomplished individuals, but there was lacking a clear skillset on that board to really help this company transition. And it really lacked skill sets around to simply energy or the oil and gas sector as a whole. There wasn’t one individual apart from the CEO that really had that skillset.

BONNIE GROVES
Some hope that you’d start to see greater director turnover that this could start a trend into this year. And this actually just hasn’t happened. John, do you think this is something that we might see more of or is it just, it was a flash in a hand.

JOHN HOEPNER
It’s a hard question. We’ve seen small bits of this in different activists, investors starting to use environmental, social governance themes and woven into their activist campaigns. But we haven’t seen a front page contested proxy like Exxon last year. The threat of the success from two years ago has really changed dynamics where I think a lot of boards are willing to meet with investors have pretty thoughtful engagement, perhaps bow earlier to shareholder resolutions. So something has shifted. I don’t know whether there’s going be a marked uptick in the next few years. It’s quite expensive to run these campaigns. So you only do this with unusual set of circumstances where you have a really large position and there’s a huge financial gain. I don’t think we’re going see it. But I think in key moments there might be similar activism.

AEISHA MASTAGNI
Exxon really was the perfect storm. The market had recognized that this was a company that had been really resistant to change. There was a lack of key skill sets that were needed on this board. And then the ability to find three nominees that ultimately made it on the board had very specific skillsets that the market recognized would be value additive to this board change doesn’t happen overnight. This is a huge company with long term capital that it’s deploying and making sure the right people in the boardroom to oversee that long term capital structure is really, really vital.
BONNIE GROVES

And that being said, I think expect to kind of headline proxy battles is a big expectation, but it doesn't mean this tactic is lost in terms of using voting rights to deploy board members. Is it something you still exercise or it's not a tactic that you really deploy often?

AEISHA MASTAGNI

Well, I don't think it necessarily has to rise to the level of a proxy contest where you're looking for other individuals and running a full-fledge contest. I think the idea of a very targeted heightened engagement is still going to take place. One of the things that Exxon demonstrated is that yes, I think it helped mitigate risk at that company and add value, but I think it had this ripple effect across the industry. You could still see that type of engagement activity at other bellwether companies in particular industries.

BONNIE GROVES

Before we look at kind of the wider environment that proxy season has sat in this year. I just wanted to ask a kind of personal question around, are there any highlights for you this year around resolutions or actions that you've seen coming out of 2022?

JOHN HOEPPNER

One of the highlights that I was most excited about was 18 months ago, legal in general, put out a position piece related to ethnic diversity on boards. And it had very clear proxy voting implications for S and P 500 and FTSE 100 companies. If you had zero assessed ethnic diversity, we were gonna vote against the board chair. Originally, there were 76 companies in our universe and over the following 18 months, we saw that number drop precipitously to this proxy voting season. In the end, there was only one company in that entire list that had no ethnically diverse directors. So to me, that was just one of these really exciting highlights. It wasn't our work alone. It happened to be that we were kind of pushing on an open door and we saw changes across the market. ISS took a change, NASDAQ changed the ruling, many of our peers issued similar reports. It was a really interesting example of when the whole industry norms around specific new standards, you can actually see really fast change. So that was a for sure, a big highlight for us.

AEISHA MASTAGNI

I'll just add that for us. We took a pretty hard stand earlier this year in advance of this proxy season. Similar to John, we put out this proxy primer where we were really going to start holding companies one accountable for greater diversity and two for basic minimal disclosures around climate risk. So what we were really looking for from companies is to disclose scope one, scope two, and to have a
TCFD aligned report. If you were missing any of those, we were voting against the entire board. Now we only applied this at large cap companies, but we think the foundation of our stewardship activities is around disclosure and transparency. We can't get our portfolio, the CalSTRS portfolio to net zero by 2050, unless we have these basic information from the companies. How can you reduce emissions if you don’t know where you’re starting from? I’m pleased to see the vast majority of large cap companies are disclosing this information, but there still are quite a few out there that are not, we’ll be looking to elevate our engagement activities with those companies going forward.

BONNIE GROVES
Good to know, looking forward to seeing it. What was important to remember is obviously the proxy season that doesn't happen in isolation. You obviously have these company-by-company engagements, but there's a wider policy environment to that's incredibly important and shifting quite a lot. It’d be interesting to hear what you think had a key changes this year that have happened in the policy environment and how that will affect proxy seasons to come.

JOHN HOEPPNER
I can jump in real quick. The varies drastically around the world, the policy environment specific to the US. You know, we are very interested in watching what the SEC does with the latest climate disclosure that impacts our portfolio companies that doesn't impact us. There's a whole lot of, there's a whole other wave of regulation that impacts asset managers and products and labelling, but that will be the signature piece of legislation that we’re keeping an eye on.

AEISHA MASTAGNI
I would just say that for us, we try to stay true to what our stewardship priorities are. There's no shortage of issues we can tackle, but what we’ve tried to do is narrow down those issues that we believe are most relevant to our portfolio. Even though we started this out by saying how difficult it is to measure success, trying to measure that success of the outcomes from those engagements. And so, we try to stay true to those principles and stay focused on things like board effectiveness, looking for disclosure and transparency when it comes to the low-carbon transition, just really staying true to those priorities in order to make for effective stewardship.

BONNIE GROVES
And how do you decide those priorities? I know that from past conversations, one topic that came up is reproductive rights. And of course, this is an area where the policy landscape has shifted dramatically legal and general voted in one way and Castros voted another. So I wonder if you are able to explain the thought process behind how you decide to vote, how you develop these positions.
JOHN HOEPPNER

New topics. We don't often have really formed policy. How legal in general, usually attacks, uh, environmental social governance topics is where there have been a catalogue of historical events. We start to form our views. We put our views in the public domain and we are pretty darn consistent across our portfolio. Reproductive rights was a new policy issue this year that we were forced to take at binary stance on, right, do you support or not support a new report? It is really, really hard for us. And so we had a thoughtful internal debate and really tried to study the heart of the issue for us. This became a broader employment question and about the welfare of the employee base. And we said, you know what, probably makes some sense for these very large retailers. I believe the resolution was at Lowe's and TJ max to really have a good understanding of what would happen in these different scenarios. Now, the challenge of course, is that that binary yes or no is going to get converted in the media to being pro-life and pro-choice, which is not really what the vote was about, but that is the ripple effect that you also have to be aware of as you are taking positions.

AEISHA MASTAGNI

And once again, we did take the opposite position on this one, just going to make CalSTRS sound like <laugh>. We actually support a whole lot of proposals, shareholder proposals. I think we just talked about two very new and very interesting subjects. This is one where I wish there was somewhere in between, but it's really a four or against we were against the proposals themselves. But we try to pair that with the really thoughtful rationale about specifics of the topic we didn't support, but we are very supportive, large employers having very good human capital management practices, which includes appropriate benefits and healthcare for their employees. And so while we didn't support the proposal specifically, I wanted to be clear in terms of our rationale for what we do support.

BONNIE GROVES

We've spoken about kind of challenges and successes of proxy season. But I wonder if you have any good failures avenues you tried to pursue that really haven't worked well, that you could share that you've adapted future attempts from any kind of good learnings that people could hear out.

JOHN HOEPPNER

One of the failures on our front last year. So that 2021, and then the proxy season 2022 was the first season that we were the lead file of shareholder proposals in the US market. And we filed a shareholder resolution at Eli Lilly calling for a quite traditional governance question, which is the separation of chairman and CEO. This has been a topic that we have been really focused on for the past three years, and we've actually taken a categorical position to vote against combined chairman CEO at every single AGM with a very straightforward rationale. I say, it's a failure in the sense that
the resolution didn't pass and I think had kind of lukewarm support. So what are we going to do differently? I don't know yet. We feel really strongly that setting governance at top helps unlock value for companies. So unfortunately I think you have to do post-mortems and you watch companies that have failures and successes and you try to learn from them. And then as those things unroll in the market, then you have to kind of remind folks what is best practice.

**AEISHA MASTAGNI**

And I'll chime in here, cuz this is one where CalSTRS really does agree with LGIM in terms of separation of the chairman and CEO. You know, we just fundamentally believe that those two positions have very different and often conflicting responsibilities. I think for a lot of companies, yes, they can go along swimmingly and everything will be fine, but when things aren't going so well, and you're trying to, maybe it's a drastic change of replacing the CEO that combined chairman and CEO really does make that process so much more difficult. We've seen it countless times. It ends up costing the shareholders money because usually there's a contract or something that's connected to that leadership role. And it just ends up once again, we, the shareholders end up paying for it.

**BONNIE GROVES**

You kind of speak about how this could cost shareholders money. Obviously you have beneficiaries who you represent, whether that's more monolithic teachers or a bigger range, how do you prioritize the hard decisions around stewardship with a company that actually might not be in the company's best interest, but as a universal owner is better for the wider market.

**JOHN HOEPPNER**

So that's a really, really hard question. So let me, let me break into two parts. So first is we represent a really diverse, as you mentioned, a diverse array of clients, but we only have one set of proxy voting policy where we have discretion. We vote one way everywhere. It is always in what we believe is the best long term interests of our clients. The second part of your question, which is, are there scenarios where individual companies actions could impact the entire portfolio? That is an absolutely growing area of, of interest of ours, of kind of systemic risks. And where is it where certain portfolio companies could behave so poorly that it could impact the whole portfolio. And you take this kind of long-term portfolio view. There are little cases where this is happening. For example, we supported a resolution at McDonald's looking at antimicrobial resistance.

**JOHN HOEPPNER**

It is definitely in McDonald's best interest to have free reign on antimicrobial resistance. They can have cheap food. It is definitely not in all of our interest for McDonald's to use way more antimicrobial resistance in a supply chain than they need. So it's a direct trade-off between portfolio
value and individual company value. Those tension points are becoming clearer. Clearer resolutions are coming on there and companies are actually engaging on them in thoughtful ways. So a lot of these companies are actually doing quite a lot of work, but they still is a fundamental tension. So, uh, we’re getting more and more comfortable supporting aggressive shareholder resolutions in this space, but it’s an area that I hope the PRI focuses on for sure our diversified investors will benefit as the market kind of matures in this space.

AEISHA MASTAGNI
And I’ll just sort of add somewhat the opposite of that. Given that we’re a public agency, we get a lot of interested parties that come to our board meetings that make comments at the board meeting. And a lot of them are calling on divestment, which means asking us not to own certain companies as part of our portfolio, we’ve really taken the position that let’s take climate change. For example, we can’t divest away climate change risk from our portfolio just because we don’t own fossil fuel companies doesn’t mean that climate change isn’t a risk to the rest of our portfolio. So we’ve taken a stance where we want to help those companies transition and be more resilient in a changing world. And so how do we do that? We engage those companies. We make sure they have the right disclosures. We try to make sure they have the right people inside the boardroom so that they have the right strategies in place. But I think that as the world changes, there will be winners and losers in terms of whether it be technology shifts, whether it be climate change. And we want to make sure that we’re helping and being good stewards of those portfolio companies to ensure that they have the biggest chance for success.

BONNIE GROVES
Well, Aeisha, John, it’s been a pleasure to talk to you today. Thank you so much for your insights. From my side, the stewardship team will be releasing a guide to filing proposals out in August and a continued program of work on board accountability and using other votes beyond shareholder proposals. You can also see a comprehensive source of ESG related resolutions of votes from our resolution database and for resources discussed in this episode, don’t forget you can access them in the episode description we would love to hear from you.

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