PASSIVE MANAGERS, ACTIVE OWNERSHIP

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Passive managers are increasingly gaining market share relative to active managers, and now own significant portions of the broad equity markets. For example, almost 40% of US equity assets under management are held in passive vehicles, more than twice the level from about 10 years ago.

But passive management should not be about just tracking a broad market index. Given their scale, passive managers are in a unique position to effect change, not only within a company but also across the wider market, on a number of important governance and sustainability issues.

In contrast to active managers, who have the ability to sell out of a holding to signal their views on the future prospects of a company, passive equity managers are, by nature, long-term shareholders. They are, therefore, just as exposed to risks around corporate governance and environmental and social concerns as active investors, while also being in a strong position to engage with and positively influence companies on these issues.

HOW TO ASSESS PASSIVE MANAGERS' STEWARDSHIP

In 2014, Mercer started formally reviewing and rating the largest passive managers on their active ownership activities, with the introduction of our environmental, social and corporate governance passive (ESGp) ratings.

Our approach focused on understanding the voting and engagement process, the resources required to implement stewardship responsibilities, internal initiatives to promote and enhance ESG integration, and the level of firm-wide commitment and industry collaboration that the managers undertake.

With these factors in mind, we assessed the extent to which these managers were exercising their ownership responsibilities.

In 2016, we revisited this research and extended ESGp ratings to a wider range of passive equity managers, who collectively control more than $4.8 trillion in passive equity assets and over $14 trillion in total assets (as at June 2016). The aim was to review each manager's progress and evaluate how industry practice has evolved in recent years.

WHAT IS BEST PRACTICE?

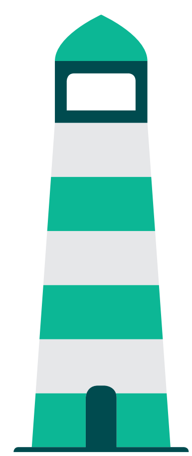
Overall, we have seen a positive trend in the development of best practice on active ownership; however, we believe more can be done. Our results showed a greater distribution of ratings across ESGp1 (highest) and ESGp4 (lowest) in 2016, compared with 2014. Attaining our highest rating is not easy, but we have seen some instances of what we would consider best practice.

We see this emerging where passive managers are considered leaders in their stewardship activities, with a consistent approach to voting and engagement at a global level. Policies should be clearly articulated and transparent, with the resources, systems and expertise in place to ensure that these activities are implemented and communicated effectively.

We expect the policies of leading managers to clearly and proactively address environmental and social issues in order to vote effectively and engage with companies, rather than abstaining or just focusing on corporate governance issues.

Best practice further demands that engagement is undertaken in a thoughtful manner and typically done at the company, industry and regulatory levels. It's not just about exercising a vote at company meetings; a level of engagement that takes place in the background is often essential in whether to vote along with company management, or even to abstain.

Leading managers are also active collaborators with other institutional investors on ESG issues, such as engaging with regulators and policymakers to drive market practice forward. The "Aiming for A" investor coalition engaging with companies and encouraging successful climate change-related shareholder resolutions is a great example of such activity.



WHERE THERE'S ROOM FOR IMPROVEMENT

Asset managers are coming under greater scrutiny, and asset owners have become more vocal in holding their managers accountable for their voting policies and actions. In particular, large passive managers have come under growing criticism for their voting actions, specifically as they relate to a perceived inconsistency between their voting policies and their public positions on various topics, such as climate change.

We believe managers need to be more clear and explicit in communicating how they implement their voting policies and why voting actions may differ from stated policies or positions. Asset owners should be aware of the rationale behind managers' votes and assess the level of engagement that managers undertake to arrive at their decision.

Most passive managers have thoughtful approaches to engaging with companies on corporate governance matters, but we believe more can be done around engaging on environmental and social issues. Data from managers has shown that engagement on environmental and social issues can range anywhere from about one-tenth to one-third of total engagements.

Furthermore, the Interfaith Center on Corporate Responsibility (which focuses on shareholder proposals during the US proxy voting season) has noted that the number of shareholder proposals generally – and climate change-related resolutions in particular – increased from 2014 to 2016. We expect this trend to continue as ESG issues increasingly appear on agendas at annual general meetings (AGMs), and believe asset managers must be clear on how they are engaging with companies to resolve these broad issues.

The International Corporate Governance Network's February 2017 article "Governance Questions Posed by the Changing US Political Landscape" reviews a range of governance challenges posed by the shifts in US politics, reinforcing the importance of a consistent voice from long-term investors.

In conclusion, as asset managers prepare to ask their investee companies challenging questions during the next round of AGMs, so too should asset owners be preparing to ask their managers how they implement their voting and engagement policies and communicate these to investors. The approaches to active stewardship can vary significantly across passive managers, and investors should have a clear understanding of what their managers are doing.

Mercer believes ESG risks and opportunities can have a material impact on the long-term risk and return outcomes; and taking a sustainable investment view is more likely to create and preserve long-term investment capital. Furthermore, we believe active ownership – through voting and engagement – helps the realization of long-term shareholder value and provides diversified investors an opportunity to enhance the value of companies and markets they hold for the long term. This is the active side of passive management, and it must not be ignored.

ABOUT THE AUTHOR

Sarika Goel is part of the Responsible Investment (RI) team at Mercer, with a focus on manager research. Since joining in 2010, Sarika has spent her time expanding Mercer's coverage of global and regional sustainability equity strategies (including environmental and other social demographic themes), and is responsible for the development of RI-related intellectual capital. She also focuses her time working across Mercer's asset class boutiques in assessing how investment managers integrate ESG factors into their investment decisions. She may be reached at sarika.goel@mercer.com.

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