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In focus

How engagement works: The road to net zero

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In the race to meet net zero emissions, companies are carefully considering their exposure to climate risk and decarbonisation ambitions. Some are leading the race by setting robust climate targets. Others are lagging, lacking resources or regulatory frameworks to execute their vision.

Investor engagement can be a tool for helping companies overcome barriers, unlock value, and manage climate risk effectively. This study looks at Schroders' engagement with investee companies on climate change and company outcomes.

It finds companies with committed engagement by Schroders on climate change are more likely than peers to set brand new climate targets and have seen accelerated decarbonisation post-engagement. Over time, these companies enjoy higher returns than peers for several years from the start of engagement, particularly for companies with higher exposure to engagement.

The race to net zero emissions

Imagine you were in a contest to get to the other side of the world without flying. How would you get there? Part of this question depends on where you are, how much you have to spend, and how you want to spend it. But at some point, all contestants will inevitably have to cross an ocean. So the question becomes, whether it's more cost-effective to cross the ocean sooner or later.

In the race to net zero emissions, companies around the world are carefully planning their journeys. For some companies, the journeys are more complicated than for others. They can face uncertain regulatory environments and limited support from government – particularly in the face of high inflation and shifting focus to energy security. How companies plan their journey to net zero will also depend on these domestic and geopolitical issues and pressures.

It helps to have advice for the journey. Investors can be a trusted partner when they understand the opportunities, pressures, and risks facing each company and share insights on how businesses can transition more effectively.

In Europe, climate action is partly driven by the labour market. Potential candidates ask what we are doing to solve the world's biggest sustainability challenges. We are seen as a climate leader but need more diverse talent in the industry. We educate primary school kids about technology and how it can help the green transition – they are our future.

Technology company, Europe

Investors and companies are fairly aligned on the energy transition, but we need an appropriate regulatory framework. The government's tax increases on zero carbon energy send the wrong signal. It becomes more difficult to invest in UK-based companies and attract international investors. There is mistrust of businesses and their needs. Investors can give an independent voice to business.

Utilities company, UK

We are in a deep economic crisis, half of the population is under the poverty line. There is limited investment in green energy infrastructure but we are slowly making progress. It will take a generational shift.

The war in Ukraine was a turning point. International investors softened their stance as inflation and energy security issues forced a different approach.

Energy company, Argentina

Schroders

Wind in the sail – engaged companies are more likely to set targets

This analysis shows that 86% of companies engaged by Schroders on climate change have a climate target[1], with 61% setting a new target or enhancing a target after the start of engagement. In contrast, 40% of unengaged companies have a climate target, with 12% setting a new target or enhancing a target after the start of engagement of their respective peers. These figures represent the progress being made across our entire engagement programme, including collaborative and sector-wide engagements (where we engage all companies in a peer group).

Digging deeper, we consider progress on a peer-adjusted basis, evaluating our influence amongst groups of comparable companies.

Our analysis shows that 16% of companies with committed engagement by Schroders – defined as at least once a year – set a brand new climate commitment or target after the start of engagement. Considering target-setting activity among unengaged peers in the same region, sector, and size group, just 4% set brand new targets over the same time frame. This is a four-fold differential.

The engagement programme underpinning our transition strategy was calculated on the assumption that engagement would result in companies being 10% more likely to establish transition plans than those we did not engage with. Our progress so far surpasses this metric.

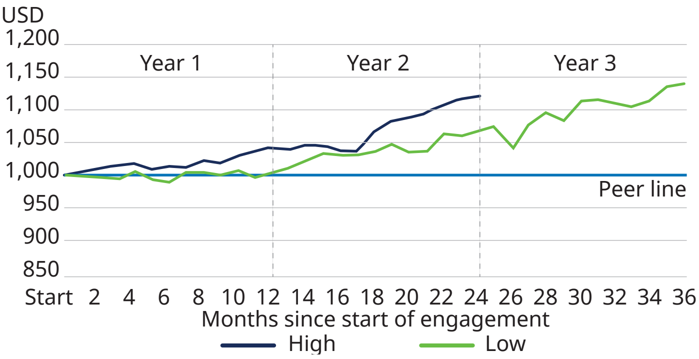
It took companies with committed engagement an average of 1.3 years to set brand new scope 1, 2, or 3 targets after the start of engagement. Where exposure to engagement was lower (1–1.99 times per year), progress was slower at 1.6 years.

Where there has been committed Schroders engagement on climate change, there was a 31% reduction in scope 1 and 2 emissions intensity from the start of engagement, compared to a 7% reduction for the unengaged peer group. Emissions intensity is measured by tonnes of carbon emitted per million dollars of sales. This is an early indication that ambition is translating to action for engaged companies, though we note it will take several years for carbon reduction strategies to mature and show outcomes.

High engagement rates are also associated with better returns. Where Schroders had engaged at least twice a year, cumulative peer-adjusted returns were 4% higher than peers after one year of engagement and 12% higher than peers after two years of engagement. For lower intensity engagements (1-1.99 times per year), returns fell in line with peers for the first year before increasing to 7% above peers two years post-engagement. They continued to rise thereafter, climbing to 11% above peers by the end of year three.

This returns analysis is based on the starting month of engagement. Companies with lower intensity engagement have been engaged for longer, therefore we could measure returns for three years after engagement at the time of publication.

Cumulative peer-adjusted returns – low vs. high engagement



Base sizes at Month 1: high – 333 companies, low – 131 companies.

1 Based on the companies included in the MSCI targets universe.

Greater exposure to Schroders engagement on climate change is associated with positive outcomes, including faster target setting, accelerated emissions reductions, and stronger returns.
With thoughtful and committed engagement, we can develop a nuanced understanding of each company's transition pathway and advocate for changes that we believe will enhance and protect value.

> Keep engaging actively. This helps us understand investor priorities and gives substance to convincing leadership to act.
>
> *Industrials company, Brazil*

> Discussions with investors can break down when there are blanket expectations and limited knowledge of asset classes, including different types of metals, minerals, and coal. We need mining for the green transition and need to manage risks effectively.
>
> In our view, divestment is not effective in driving action – it might lead to a concentrated ownership base that excludes ESG-focused and long-term investors. Informed dialogue is most effective in determining how mining companies contribute to a just transition.
>
> *Mining company, Australia*

The art of the deal – effective engagement requires collaboration

Making progress requires cooperation, whether crossing the globe or transitioning business models to lower carbon emissions. When we engage with investee companies on climate action, we often have to work with people we've never met before, with different cultures and political views. Taking the time to understand the person, the business, and the external pressure is important. Thoughtful engagement helps to identify the potential policies and plans in which both parties mutually benefit.

In late 2021, we committed to supporting companies in meeting the goals of the Paris Agreement with the launch of the Climate Transition Action Plan (CTAP). Engagement with investees intensified around net zero target setting and energy transition planning. We also continue to engage on other aspects of climate risk and transition, including operational safety, supply chain management, and impact on biodiversity.

Click here for an interactive visualisation of engagements over the study period.

> The accelerating frequency of extreme weather events is additional evidence the risks from climate change are real. Investors are increasingly asking what carbon and physical risks mean for credit risk. The conversation on ESG needs to be deeper than binary tick-box forms and high-level screening given the complexity of business models. Investors have a responsibility to make informed decisions as stewards of climate action.
>
> *Financial institution, UK*

> It's clear companies need to take climate action. We want to understand what is and isn't working in Europe – and what that means for companies in the US. We need more investor engagement, especially outside of proxy season. We want to listen as much as talk.
>
> *Consumer goods company, US*

> International investors recognise the opportunity of a green transition whereas domestic authorities are focused on risk management. Understanding risks and opportunities requires data. Investors can help us understand the right tools, methodologies, and challenges. Together we can identify areas for growth and allocate capital effectively.
>
> *Financial institution, Greece*

Case study: Financing the green transition

Banks are facing substantial financial, regulatory, and reputational risks due to the global transition to a low-carbon economy. While the carbon footprint of a bank's operations – such as its offices and branches – is relatively small, the emissions financed by the bank through its clients can have a considerable impact on the planet. Therefore, the key metric for banks in the context of climate change is their 'financed emissions'. Banks have a vital role to play in supporting their clients' transitions away from high-emission activities.

Our engagement with this company on climate change has been intensive and consistent, with discussions taking place around three times a year since 2020. However, our first recorded engagement with the company on this topic dates back to 2008. These engagements, currently led by our European Equity team, have been part of our research into fossil fuel financing (including oil sands financing) and broader banking engagement across Europe.

Initially, we encouraged the company to measure emissions related to its financing activities, set climate targets, and develop robust climate policies. As the company has made progress, our recent engagements have become more technical, focusing on the scope and completeness of its targets, assurance over emissions measurement, and reporting on client transition.

In 2020, the bank took a significant step by announcing its commitment to Net Zero emissions. It developed a target methodology in the same year and set targets for two major sectors – energy and power. As of 2023, the bank has set emission reduction targets for six high-emitting sectors. It has also announced a $1 tn target to provide sustainable and transition finance to clients, accompanied by a client transition framework to support the shift to lower-carbon business models.

The bank's absolute emissions linked to its financing of the energy sector have fallen by approximately a third over the last three years, indicating significant progress towards its climate goals. The company has now committed not to provide financing for oil sands exploration and production companies, or to provide financing for the construction of new oil sands production or processing assets or pipelines.

Conclusion

The race is on for the net zero transition. Companies are drawing up roadmaps for effectively managing climate risks and unlocking opportunities. Investor engagement can be an effective tool for helping companies chart their transition pathways.

The progress demonstrated by this analysis is reassuring for responsible investors. Overall, engaged companies are over twice more likely to have a climate commitment or target than unengaged companies. But setting a decarbonisation target is relatively easy: calculate the baseline emissions, establish targets, and define the line that connects them. However, we approach climate change as an investment challenge, rather than a constraint to operate within – a tailwind to investment performance rather than a headwind.

Climate action must be embedded within the investment process and this analysis demonstrates the potential reward. Companies with committed engagement from Schroders see higher returns than peers for several years from the start of engagement, culminating at 7% above peers by the end of year two with lower levels of engagement. For higher levels of engagement (at least twice a year), cumulative returns stood at 12% above peers over this time.

Valuation and fundamental insights are critical to ensuring that climate exposures are considered alongside a myriad of other factors. Thoughtful engagement is key. Having a good understanding of the regulatory and geopolitical pressures facing investees helps set realistic milestones along the net zero journey and unlock long-term value.

Methodological note

About this research

Active investors like Schroders believe that engaging with their investee companies leads to better performance, whether on social, environmental or governance issues. Understanding how engagement works – where efforts do and don't lead to better performance – is critical to spending time and energy where it counts most. This research aims to quantify the relationship between Schroders' engagement on climate change and company performance.

Through engagement, Schroders' investors understand the potential value of a company and make an investment decision on that basis. With continued engagement investors may keep abreast of emerging issues or advocate for changes they believe will improve a company's financial, social, or environmental performance. At Schroders, determining investment value and engagement are two sides of the same coin. This research adds to the body of evidence on the association between investor engagement and company outcomes.

Research limitations

Overall, studying the association between investor engagement and investee performance is a challenging task. Since we cannot observe the entire universe of engagements by other stakeholders, we remain cautious in identifying which ones affect firm behaviour.

Investor behaviour, market dynamics, regulations, and societal expectations can all alter how a company responds to operational, financial, and reputational risks. Studying the long-term value of a company based on its engagement exposure can be hampered by changing market regimes and wide-spread economic disruption. For example, emissions and financial performance were heavily impacted during Covid-19.

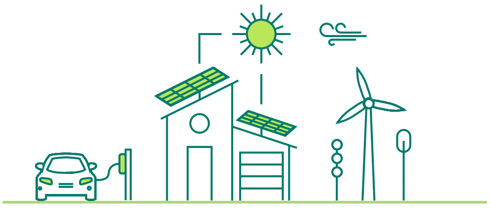
Some engaged companies were excluded from the peer-adjusted analysis because they did not have a peer group for comparison. This happens when we engage all companies in that sector-region-size basket, for example large British financial institutions.

We do not consider voting behaviour in this research because too high of a proportion of companies with significant votes on climate-related topics do not have an unengaged peer group.

Interpreting climate targets

Scope 1, Scope 2, and Scope 3 are different categories of greenhouse gas (GHG) emissions that an organisation can measure and manage. The difference between them lies in the source of the emissions and the level of control that the organisation has over them.

Scope 1 emissions are direct GHG emissions that occur from sources that are owned or controlled by the organisation. This typically includes emissions from on-site fuel combustion, such as emissions from company-owned vehicles, boilers, or manufacturing processes. Scope 1 emissions are considered short-term targets as they can be directly controlled by the organisation.



Scope 2 emissions are indirect GHG emissions that result from the generation of purchased electricity, heat, or steam consumed by the organisation. These emissions occur at the source of electricity generation, such as power plants. Scope 2 emissions are also considered short-term targets as they can be influenced by the organisation's choice of energy sources. Organisations can reduce their Scope 2 emissions by using renewable energy or improving energy efficiency.

Scope 3 emissions are all other indirect GHG emissions that occur as a result of the organisation's activities, but are not owned or controlled by the organisation. These emissions include the entire value chain of the organisation, including activities such as procurement, transportation, product use, and disposal. Scope 3 emissions are considered long-term targets as they require collaboration and influence across the value chain. They can be challenging to measure and manage due to the involvement of external stakeholders.

Data points

Climate targets

Climate targets are obtained from MSCI for the MSCI universe. Companies without a ticker or ISIN identifier are excluded from analysis. The below fields are used to determine target type:

- TARGET_CARBON_SCOPE_123_CATEGORY
- CBN_TARGET_DESC

Where the carbon scope category is missing, the target description is classified by keyword search into the following categories:

- Scope 1 and 2
- Scope 3
- Other target

Companies with no target type and no description are classed as no target. Targets are then summarised by company in a binary format and target type (e.g., have target = 1, no target = 0). An additional aggregate field is added for any target, if a company has any of the above targets or commitments.

Emissions intensity

Scope 1 and 2 emissions intensity is obtained from MSCI for the MSCI universe. Companies without a ticker or ISIN identifier are excluded from analysis. Emissions intensity is defined as tonnes of carbon emitted per million dollars of sales.

Returns

The total return incorporates the price change and any relevant dividends for the specified period. Compounded daily return for the specified period is used to calculate total return. The dividend type used is the most widely reported dividend for a market. Cumulative returns are used to assess financial performance. Returns are obtained by month from January 2010 to November 2023 via Refinitiv Eikon.

Engagements

Engagement data is sourced from ActiveIQ, Schroders' proprietary tool for recording and reporting ESG engagements. This research covers 2,744 engagements with 1,351 companies across 61 countries between January 2010 and June 2023. The study period commences in 2010 to maximise the amount of historical data available for analysis, from an engagement and performance perspective. Companies not in the MSCI universe are excluded from analysis.

The following engagement subthemes are considered in the analysis:

- Climate alignment, including Net Zero target setting
- Carbon capture and removal
- Climate risk and oversight
- Climate adaptation
- Just transition

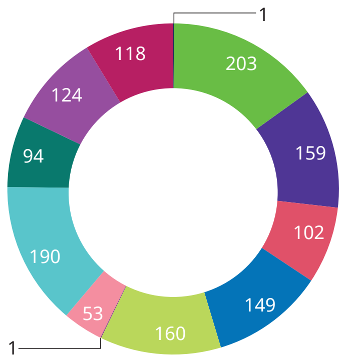
Engagements are summarised by issuer using ISIN as the primary identifier. Companies without an ISIN are excluded from analysis. Engagements are summarised by year and month to calculate the starting month of engagement for each company.

The total number of engagements is calculated by year from the starting month of engagement. We then determine the average number of engagements per year to build the engagement segments. Companies are classified into engagement segments as follows:

- 2+ engagements per year = High
- 1 to 1.99 engagements per year = Low
- Less than 1 engagement per year = Limited

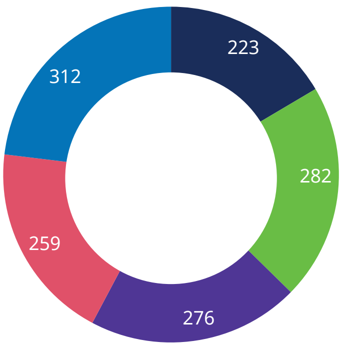
Study Group characteristics

The sectoral breakdown of the study group is as follows:



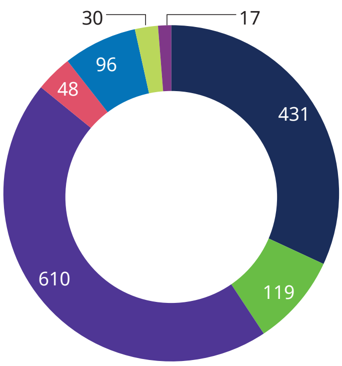
- Academic and Educational Services
- Basic Materials
- Consumer Discretionary
- Consumer Staples
- Energy
- Financials
- Government Activity
- Healthcare
- Industrials
- Real Estate
- Technology
- Utilities

The regional breakdown of the study group is as follows:



- Asia Pacific
- Europe
- North America
- UK
- Rest of the world

The size breakdown of the study group is below, which considers a company's growth trajectory over the study period.



- Large
- Medium to large
- Medium
- Small to medium/large
- Large to medium/small
- Medium to small
- Small

Peer group construction

The research includes a peer group assessment, comparing climate targets, emissions and returns of engaged companies with an unengaged set of peers who have similar characteristics. The peer groups are based on company size (including growth trajectory over the study period), sector, and region (including market maturity). This ensures that engaged companies are compared to a set of unengaged peers who are exposed to similar ESG issues and regulations, helping to isolate the engagement factor from wider market forces driving performance and returns.

The MSCI universe is used for this research. Engaged companies excluded from the MSCI universe are excluded from this research.

Size

Company size is based on market capitalisation in USD. The company market cap represents the sum of market value for all relevant issue level share types. The issue level market value is calculated by multiplying the requested shares type by the latest close price. This data is obtained via Refinitiv Eikon. Market caps are obtained for all companies in the MSCI universe.

Company sizes are assigned based on the earliest and latest market cap over the study period from 2010, relative to the sector-region peer group. First, market cap data is obtained for all companies. If market cap data is missing, the earliest and latest available dates are taken instead. Companies with less than two years of market cap data are excluded from analysis.

Then the company market cap is calculated relative to peers in the same region and sector. First, the market cap data is summarised using the sector-region average and standard deviation. These figures are then used to calculate z-scores for each company's market cap.

The resulting z-score is reclassified so the data falls into three equal size segments (large, medium, small). Companies with a z-score over 0.42 are classed as large; companies with z-scores falling between -0.42 and 0.42 are classed as medium; companies with z-scores below -0.42 are classed as small.

The growth trajectories for each company are determined based on their earliest and latest available size in the study period. They are then grouped as follows:

- Large
- Large to medium/small
- Medium
- Medium to large
- Medium to small
- Small
- Small to medium/large

Using the growth trajectory of each company allows us to control the effect of business maturity when comparing performance of engaged and unengaged companies. Companies with no information on size (market cap) are excluded from further analysis.

Economic Sector

This analysis uses the Thompson Reuters Business Classification Economic Sector. The sector classification is:

- Academic and Educational Services
- Basic Materials
- Consumer Discretionary
- Consumer Staples
- Energy
- Financials
- Government Activity
- Healthcare
- Industrials
- Real Estate
- Technology
- Utilities

Region

The regions used for analysis reflect the structure of the engagement team at Schroders, as well as the political and regulatory landscape in each region. The UK, Europe, developed Asia-Pacific, and North America are separated in the analysis. Our engagements are more mature here with more advanced discussions on regulations. Developing markets, including Latin America, Africa, and the Middle East, are grouped in the analysis. Our engagements and the regulatory landscape are more nascent here.

Climate targets analysis

We consider the proportion of engaged companies with commitments and targets compared to non-engaged companies, as a measure of progress for the overall engagement programme. This includes sector-wide engagements where we have engaged all companies in the region-sector-size peer group.

The deep-drive analysis essentially looks at how many engaged companies set targets after the start of engagement. This is compared to target-setting activity occurring among the unengaged peer group based on this date milestone – how many unengaged companies set targets after their engaged peer's engagement start date.

First, the peer group information is added to the climate targets dataset from MSCI. Companies with missing peers are identified – where we engaged all companies in the sector, region, and size peer group. These companies are excluded from the peer-adjusted analysis.

A full join is performed in Alteryx by peer group, using the following datasets:

- Engagement by company for high and low engagement segments, including engagement start date (each row is an engaged company)
- All peer group targets including the target announcement date (each row relates to climate targets for the unengaged peers)

Where there is no peer group match, records are excluded from analysis. Where there is a target but no announcement date, records are excluded from analysis. Target announcement dates before 2010 are classed as January 2010.

For each combination of engaged company start date and peer group company target announcement date, we determine whether the target was set before/during or after the start date of engagement. Then, targets information is summarised by company, target type, and target timing (before/during and after the engagement start date). Overall progress metrics are calculated for companies setting a new target with no prior history of having such a target, as well as additional targets with some history of climate commitments. Binary coding is applied to the overall progress metrics.

Next, the target-setting figures for unengaged peers are adjusted by the representation of that peer group amongst engaged companies. First, we determine the proportion each peer group contributes to the engaged companies' dataset. This is divided by the number of companies in each unengaged peer group. The weight is then applied to the binary coding of target progress for each company and summarised for the unengaged dataset. The target progress of engaged companies is also summarised, excluding companies with missing peers.

Finally, the analysis also looks at the length of time taken to set different types of targets depending on the engagement approach. For companies setting targets after the start of engagement, the number of days and years is determined between the start of Schroders engagement and the minimum time taken for each company to set a commitment or target.

Emissions intensity analysis

Emissions intensity (tonnes of carbon emitted per million dollars of sales) data is obtained from MSCI. The earliest and latest emissions intensity is determined for each company based on the starting year of engagement. For example, if a company was engaged in April 2021, the earliest emissions would be from FY2021.

Companies with less than two years of available data are excluded from analysis. This analysis features a smaller base size than the targets and returns analysis because data is available on an annual basis with lower coverage. We also note it will take several years for carbon reduction strategies to mature and show outcomes.

The earliest and latest emissions intensity data is summarised by issuer for those with high and low exposure to engagement. Next, a "synthetic" dataset is created for the unengaged peer group. The real emission intensity data of engaged companies is replaced by their unengaged peer group average.

To calculate the unengaged peer group average, the emissions intensity data is summarised by the sector-region-size peer group, excluding all engaged companies (high, low, limited). Then, a "synthetic" dataset is created where the real returns data of engaged companies is substituted by data from the unengaged peer groups.

Returns analysis

Returns are obtained through Refinitiv Eikon on a monthly basis from January 2010 to November 2023 for companies with high and low intensity engagement. This means the latest cutoff date for engagements (June 2023) would have a minimum six months of returns data for analysis. The returns data is smoothed to mitigate the impact of excessive peaks and troughs that would skew aggregate returns. Returns below -50% are capped at -50%, while returns over 100% are capped at 100%.

The returns data is summarised by the sector-region-size peer group, excluding all engaged companies (high, low, limited engagement intensity). Then, a "synthetic" dataset is created where the real returns data of engaged companies is substituted by data from the unengaged peer groups. The unengaged peer group data is subtracted from engaged company data to obtain peer-adjusted returns.

Natural Language Processing

The engagement notes are analysed using a Natural Language Processing algorithm in Alteryx for the interactive visualisation of engagements over the study period. Where the summary note and further detail notes are the same, the summary note is taken. Where they are not the same, the notes are concatenated. Large-scale engagement campaigns are excluded from this analysis given their dominance in textual prevalence results.

The final list of words and topics is reviewed to remove any terms that could be interpreted very widely and does not enhance the analysis. This includes words like "appear", "don't", and "overall". The list of words is further filtered to only include those appearing in the top 15 words for each engagement segment or topic. The visualisation shows the words used in engagement summary notes, which topics they relate to, and the strength of that relationship.

Key Informant Interviews

A series of Key Informant Interviews were conducted as part of this research to understand the barriers and opportunities for investor engagement on climate change. Nine interviews were conducted with Investor Relations departments of companies across a range of sectors and regions covering the following questions:

Discussion questions

- How much influence do you think investors have on climate action? How can engagement on climate and environmental issues be improved? How much of a challenge is investor pressure when it comes to company climate strategy?
- How does your company balance the needs of different stakeholders, including but not
- Limited to investors, when it comes to climate action? Are there any conflicting views?
- What is your understanding of climate portfolio targets being set by investors on climate change? How do you think these targets are impacting/influencing investments your company?
- Do you think there is enough nuance in the way investors engage with your company on climate change e.g. by size, region or sector?
- Do you think your progress on climate action is effectively being tracked and benchmarked by investors?
- How do you think issuers, investors and others could work more effectively together to create systemic change to improve the operating environment for companies (eg climate regulation)? What examples do you know of effective collaboration to achieve such change?
- How can investors strike the right balance between engaging collaboratively on climate change (e.g., through the IIGCC) and directly with investees?
- To what extent do you think climate engagement is being influenced by political events or campaign groups?
- How should investors escalate concerns on climate action with your company? How effective is divestment on your company's actions and strategy?

Further reading

This research was informed by the following studies on the value of investor engagement:

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The Big Three and Corporate Carbon Emissions Around the World. Journal of Financial Economics (JFE), Forthcoming, Proceedings of Paris December 2020 Finance Meeting EUROFIDAI – ESSEC, European Corporate Governance Institute – Finance Working Paper 715/2020, Available at SSRN.

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Becht, M., Franks, J., Mayer, C., & Rossi, S. (2009).
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Important Information

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