Engaging Asset Managers to Responsibly Steward Fund Assets and the Systems that Support Them

A BRIEF GUIDE FOR THE TRUSTEES AND STAFF OF DIVERSIFIED ASSET OWNERS

INTRODUCTION

The ability of asset owners to meet their long-term financial goals is severely challenged by risks such as climate change, persistent income inequality, and the inequitable delivery of healthcare that threaten our planet and its people. Because they impact all economic participants and demonstrate the interdependence of all players, these risks are considered systemic. They transcend the traditional view of investment risk as something to be assessed solely on a company-by-company basis because they impact the entire portfolio. To meet this challenge, investors must reorient their investment managers towards a stewardship model that considers these systemic concerns and adopts a more holistic portfolio perspective. This guide is meant to provide asset owners with the tools and resources to engage their managers on the system stewardship model. Investors should consult with counsel with regard to questions concerning fiduciary or other obligations.

THIS GUIDE HAS FIVE PARTS:

PART I:
THE CASE FOR SYSTEM STEWARDSHIP

THE ROLES OF FUNDS, TRUSTEES, STAFF, AND EXTERNAL MANAGERS

Pension funds, endowments, foundations, and other institutions hold assets in trust for the benefit of workers, universities, communities, and other beneficiaries. Trustees of these institutions establish investment policies and oversee the management of these funds, while internal staff implement these policies, often through the retention of external professional asset managers.

PERFORMANCE MEASURES FOR ACTIVE AND PASSIVE MANAGERS

The performance of external investment managers is generally measured against a benchmark: how has the financial return of the managed assets compared to that of an appropriate set of similarly risky assets? In general, asset management styles fall into two categories that correspond to two types of performance measurement:

- **“Active” managers** are charged with selecting investments with a goal of outperforming the benchmark. For active management, the critical performance measure is “alpha”—the measure of risk-adjusted return compared to the entire benchmark.
- **“Passive” managers** are those charged with safely delivering the relevant market’s overall return (“beta”); this roughly corresponds with indexing. For passive management, the measure of performance is “tracking error”: how closely did the manager come to matching the benchmark?

In addition to alpha and tracking error, asset managers are also assessed on the fees they charge.

TYPES OF STEWARDSHIP

In addition to selecting assets, managers steward the performance of the assets that they have selected. Stewardship can take multiple forms, but there are four important aspects:

- **Voting:** Generally, the owners of common stock can vote on measures such as the election of directors, executive compensation, shareholder proposals, and other matters. For example, an investor might vote against executive compensation in light of poor financial performance.
- **Direct engagement:** Investors can meet with and engage companies to encourage certain disclosures and practices, and can also propose matters for action at annual meetings. For example, an investor who believes that the treatment of workers impacts investment returns might meet with a company to discuss human rights due diligence in the company’s supply chain.
- **Policy engagement:** Investors can also influence laws and regulations that impact significant business practices. For example, an investor who believes that climate change presents a risk to their investments might support laws that require certain companies to lower their carbon emissions.

- **Security selection:** In some instances, determinations whether to purchase or sell a security may influence decisions for the issuer. For example, a significant threat of divestment could impact a company's reputation, and decisions not to participate in new financing can impact a company's cost of capital. These outcomes could lead companies to avoid behavior that would lead to such investment decisions.

BETA DETERMINES WHETHER ASSET OWNERS CAN SATISFY THEIR OBLIGATIONS AND PURPOSES

For asset owners to meet their obligations to their beneficiaries, it is important to have an adequate "absolute return". This is the actual financial gain that a fund realizes through interest, dividends and capital gains. The absolute return equals the return of the benchmark in which the fund is invested, adjusted for the alpha (or tracking error) of its portfolio, minus fees paid:

$$\alpha \pm \beta - \text{fees} = \text{absolute return}$$

To take a simplified example, a pension fund might own a 60/40 portfolio of global equities and debt. If, over a ten-year period, that benchmark earns an annual return of 6%, and if its managers achieve 1% above the market and charge total fees of 0.5% annually, then the fund will earn a 6.5% compounded annual return:

$$6\% + 1\% - 0.5\% = 6.5\%$$

If this return is not sufficient to pay the retirement liabilities owed to the workers it covers, it will have to increase the contributions from employees or their employer (or taxpayers in the case of public employees).

As noted above, the performance of asset managers is generally assessed based on two of the three factors that make up absolute return: alpha (tracking error for passive managers) and fees. Ironically, however, the vast majority of variance in absolute return consists of exposure to beta—the overall market return: for active managers, 75-94% of variance in return is based on the general price level of the capital markets, not the securities in the portfolio. Of course, for passively managed assets, all of the return (other than tracking error) is composed of the market return for the chosen allocation.

THE NEED FOR ASSET MANAGERS TO ENGAGE IN STEWARDSHIP

Stewardship is a critical tool for investors to improve beta, which, as discussed in the last section, is the primary contributor to the financial returns available to satisfy a fund's obligations. Stewardship can be used to encourage company practices that protect the critical economic systems that support economic resilience and growth. For example, investors can vote their shares in a manner that discourages excess emissions of greenhouse gases that disrupt the global climate and threaten the long-term returns of fund portfolios. In addition, investors can seek to influence public policy to create emissions limits.

WHEN ALPHA AND BETA COLLIDE

The individual performance of a company may be enhanced in the short term by externalizing social and environmental costs. For example, a company may seek to reduce costs by tolerating worker abuses and polluting the environment.

While these practices may increase profits and the alpha of active portfolios that include the company, they create risks for the systems that undergird the global economy and will damage the long-term financial performance of global capital markets upon which investors rely.

Managers tend to overlook beta factors because they do not appear in relative performance measures. Any contribution to beta from individual companies selected by asset managers is shared equally among all market participants and does not appear in a manager's relative performance metrics. In contrast, alpha is very salient: there is little question as to whether a manager is delivering more or less alpha than its competitors.

This sets up a perverse reward structure that may cause asset managers to sanction and even encourage beta-threatening behavior by portfolio companies, even though beta is the most important factor in determining whether funds will be able to meet their obligations.

PART II:
A COMPENDIUM OF KEY CONCEPTS AND ELEMENTS OF SYSTEM STEWARDSHIP

This part dives a bit deeper into system stewardship, including portfolio diversification, externalized costs, and operationalization.

DIVERSIFICATION

- **The need for diversification.** Investors must diversify their portfolios in order to optimize the combination of risk and reward. Fiduciary responsibilities require diversification of funds held on behalf of beneficiaries.
- **Diversification may manifest at the beneficiary level.** Even where individual funds are concentrated in industries or positions, the ultimate beneficiaries of those funds are likely to be diversified.
- **Importance of overall market return to diversified investors.** Once a portfolio is diversified, the most important factor determining return will not be how the companies in that portfolio perform relative to other companies ("alpha"), but rather how the market performs as a whole ("beta"). As discussed above, the market return of the chosen allocation is responsible for 75% or more of the variance among portfolios.
- **However, some practices that increase company profit can negatively impact overall market returns.** Company practices that increase revenue and margins can create costs that impair macroeconomic performance. For example, a company may save costs by using relatively cheap, carbon-intensive energy, but contribute to climate change, which threatens companies, the economy, and investment portfolios.

RELATIONSHIP AMONG MANAGERS, EXTERNAL COSTS, AND DIVERSIFICATION

- The best interests of diversified clients can deviate from the interests of individual companies in the portfolios being managed on their behalf due to the relationship between externalized costs and broad economic performance.

- A unitary focus by an asset manager on maximizing value at the portfolio company level threatens the diversified portfolios of clients (and their beneficiaries), who rely on healthy social and environmental systems to support their investments over the long term.

- Trade-offs of economy-wide risk for financial gain at the individual company (or portfolio) level cannot be ignored without undermining the financial interests of the vast majority of beneficiaries of an asset manager, who diversify their portfolios. This is true even for beneficiaries of funds or accounts with concentrated holdings because such funds or accounts are likely only a portion of the assets owned by or on behalf of such beneficiaries.

> ***When portfolio companies externalize costs that affect the portfolios of asset managers, a value trade is being made within those portfolios. For example, if a portfolio company saves costs with cheaper, carbon-intensive energy, it is trading away climate mitigation (which supports the economy's value) in exchange for more internal profit at the individual company. While this trade might financially benefit that company, it can harm the diversified clients of a manager (and that manager's own diversified funds) by threatening beta.***

IMPLICATIONS FOR MANAGER STEWARDSHIP RESPONSIBILITY

- In order to best serve its predominantly diversified clients, an asset manager should account for the effect that portfolio company decisions have on the economy and, consequently, the portfolios of diversified investors.

- Investment and stewardship decisions should not be made solely on the basis of their effect on the individual company; instead, the asset manager's calculus should include the broader systemic impact of its decisions.

- Managers need not reflexively make choices that favor systems; what is critical is that the systemic and portfolio impact be included in the analysis.

KEY ELEMENTS OF AN ASSET MANAGER PROGRAM

Guardrails

- External managers should recognize the tension between the business imperative to maximize returns at individual companies and the legitimate interest of diversified shareholders in ensuring that their capital is not used in a manner that creates threats to the social and environmental systems that diversified portfolios rely upon. An important tool for resolving such tensions is the establishment of guardrails that proscribe certain corporate practices that threaten systems, even if such practices might be value-enhancing at the individual company. Corporations should strive to maximize returns within such shareholder-mediated guardrails.

Systemic Impacts Must Be Accounted for

- Voting, engagement, and security selection decisions made with the intent to impact company activity should account for full portfolio effects.

- There is no "neutral" ground, as failure to account for externalities can favor concentrated holders over diversified. Given the prevalence of diversification, managers should, at a minimum, default to policies that account for diversification.

Pass-Through Opportunities Enable System Stewardship

- Where clients are offered the opportunity to vote shares in pooled or segregated accounts, asset managers should ensure that the policies made available include policies that consider the impact votes have on diversified portfolios.
- The availability of pass-through voting does not eliminate the need for asset managers to address systemic issues and engage in responsible stewardship that benefits the overwhelming majority of their clients who are diversified and entrust the manager to vote proxies on their behalf. However, such a pass-through voting option will give investors who have a different view on systemic issues the ability to make their own choices and ensure that investors are not forced to vote in lockstep.

Policy Advocacy

- Policy advocacy by asset managers should reflect the diversified nature of most of the economic beneficiaries of their services.

PART III:
QUESTIONS FOR ASSET OWNERS TO USE IN ENGAGING ASSET MANAGERS ON SYSTEM STEWARDSHIP

Questions you can ask external managers to begin a conversation around system stewardship.

- When you undertake an engagement with a portfolio company, do you consider the impact that engagement might have on our entire portfolio?
- When you vote shares in portfolio companies, do you consider the impact that the vote might have on our entire portfolio? Please describe the process used to do this broader assessment as you vote.
- Does your engagement strategy account for the fact that the absolute return we receive is largely dependent upon the health of the overall market, and that is, in turn, dependent on the health of the environmental, social, and financial systems? If so, how do you factor those relationships into your stewardship philosophy and program?
- Do you believe that public policies that protect critical systems can benefit long-term investing results? If so, do you commit resources to public policy advocacy?
- Do you participate in policy debates/lobbying/testimony? How do you consider the needs of your diversified owners in those activities? Can you provide examples?

- When making choices about the stewardship in which you engage, do you ever find the goal of maximizing value at an individual portfolio company to be in conflict with maximizing the overall returns in the market, and if so, how do you resolve that conflict?
- If you provide pass-through voting options, do any of the offered policies consider the impact of the votes on diversified portfolios as distinct from the impact of votes on the performance of the company where the vote takes place?
- Have you published any thought leadership on these issues?

PART IV:
SAMPLE CASE STUDIES OF A PORTFOLIO-FIRST ASSET MANAGEMENT POLICY

Solely for illustrative purposes, we provide two examples of policies that might be adopted by an asset manager demonstrating appropriate attention to system stewardship:

1. CLIMATE

Manager recognizes that failure to conform to climate goals, such as the Paris goals, threatens to reduce the value of diversified portfolios by 30% or more,[1] so that any gain for the prospects of an individual company that depends upon the company exceeding a fair Paris-aligned GHG budget is likely outweighed by threats to typically diversified portfolios. Therefore, Paris alignment is an appropriate guardrail for shareholders to require companies to stay within. That guardrail will be implemented through the following tactics:

a. **Voting.** Manager will support proposals and other measures, including campaigns to withhold director votes, if it determines such actions are reasonably calculated to encourage the company to align with the Paris goals, unless the manager determines that such support will not improve the returns of diversified portfolios.

b. **Security Selection (for actively managed portfolios).** Manager will avoid debt financing and other primary purchases of securities in companies that are not aligned with Paris or similar goals, unless it determines that such purchases will not contribute to a failure to meet such goals. When purchasing and selling shares in the secondary market, Manager will consider the impact of such transactions on the likelihood that the Paris goals will be met.

1 See Rebonato, R., D. Kainth, and L. Melin (2024) *How Does Climate Risk Affect Global Equity Valuations? A Novel Approach*, EDHEC-Risk Climate Impact Institute, EDHEC Business School (July) (economy's current greenhouse gas emissions trajectory may lead to a rerating of the entire equities market of 30-40% in comparison to a Paris-aligned economy.), available at **https://climateimpact.edhec.edu/publications/how-does-climate-risk-affect-global-equity**; see also, Rachel Teo and Willemijn Verdegaal, *Integrating Climate Scenario Analysis into Investment Management: A 2023 Update, 23*, (predicting that failure to address climate will reduce compound returns on an average portfolio by 30% over the next 40 years, compared to returns in an economy that successfully achieves net zero) available at **https://www.gic.com.sg/wp-content/uploads/2023/04/GIC-ThinkSpace-Climate-Scenario-Analysis.pdf**

c. **Policy.** It is unlikely that the Paris goals will be met without government policy changes. Accordingly, Manager will utilize its ability to engage and vote to discourage companies from engaging in influence campaigns to interfere with appropriate policy action, whether directly or indirectly through trade associations. Manager will also advocate for appropriate climate policies on behalf of its clients.

2. LIVING WAGE

Manager recognizes that inequality represents a significant threat to GDP,[2] so that any increase in the prospects of an individual company that depends upon the company paying low wages is likely outweighed by threats to typically diversified portfolios. Therefore, shareholders may appropriately establish living wage certification as a guardrail calculated to optimize portfolio-wide returns. That guardrail will be implemented through the following tactics:

a. **Voting.** Manager will support proposals and other measures, including campaigns to withhold director votes, if it determines such actions are reasonably calculated to encourage the company to pay living wages throughout its value chain, unless manager determines that such support will not improve the returns of diversified portfolios.

b. **Security Selection (for actively managed portfolios).** Manager will avoid debt financing and other primary purchases of securities in companies that do not pay living wages or have policies reasonably designed to move toward a living wage for their workers unless it determines that such purchases will not contribute to a reduced economic value. When purchasing and selling shares in the secondary market, Manager will consider the impact of such transactions on the likelihood that the economy will remain under the threat of low wages.

c. **Policy.** Government policy changes are critical to raise low wages. Accordingly, Manager will utilize its ability to engage and vote to discourage companies from engaging in influence campaigns to interfere with appropriate policy action, whether directly or indirectly through trade associations. Manager will also advocate for appropriate wage policies on behalf of its clients.

PART V:
RESOURCES AND FAQS FOR TRUSTEES

Barnett, Jake, and Patrick Peura. ***The Future of Investor Engagement: A Call for Systematic Stewardship to Address Systemic Climate Risks.*** UN-convened Net-Zero Asset Owner Alliance, Apr. 2022, https://www.unepfi.org/wordpress/wp-content/uploads/2022/03/NZAOA_The-future-of-investor-engagement.pdf.

Stewart, Katie, ***Universal Ownership: A Guide for Charity and University Asset Owners*** (2025), https://shareaction-api.files.svdcdn.com/production/resources/reports/Universal-Ownership-CRINU-Final.pdf?dm=1743076334. Paper provided to the Charities Responsible Investment Network (CRIN) and Responsible Investment Network – Universities (RINU).

2 See The Business Commission to Tackle Inequality, *Tackling Inequality: The Need and Opportunity for Business Action* (closing the living wage gap worldwide could generate an additional USD4.56 trillion every year through increased productivity and spending, more than 4% of global GDP.)

CFA Institute, Global Sustainable Investment Alliance, and Principles for Responsible Investment, ***Definitions for Responsible Investment Approaches***, (2023), https://rpc.cfainstitute.org/-/media/documents/article/industry-research/definitions-for-responsible-investment-approaches.pdf. Paper defining stewardship as enhancing "common environmental, natural, intellectual, social, and institutional assets that underpin all economies."

Freshfields Bruckhaus Deringer, ***A Legal Framework for Impact: Sustainability Impact in Investor Decision-Making***, 2021, https://www.freshfields.com/globalassets/our-thinking/campaigns/a-legal-framework-for-impact/a-legal-framework-for-impact.pdf. Comprehensive legal analysis of fiduciary obligations supporting the need for system stewardship.

Lukomnik and Hawley, ***Moving Beyond Modern Portfolio Theory: Investing that Matters***, 2021, Routledge. Book outlining finance and economics of system stewardship.

Peres da Costa and Chandler, ***Active Ownership 2.0: The Evolution Stewardship Urgently Needs***, 2019, https://www.unpri.org/download?ac=9721. Principles for Responsible Investment publication outlining case for system stewardship.

The Shareholder Commons, Closing ***The Engagement Gap: Low Wages/Inequality, Climate Change, And Antimicrobial Resistance*** (2022-2023), https://theshareholdercommons.com/case-studies/. Three case studies demonstrating risk to diversified shareholders of individual companies maximizing returns without accounting for impact of externalities on diversified portfolios.

SYSTEM STEWARDSHIP FAQS FOR TRUSTEES

Q: What is system stewardship?

A: System stewardship is the work that investors do to protect the social, environmental, and economic systems that are vital to the financial returns of their whole portfolios.

Q: Why should we engage with our external managers about system stewardship?

A: Such engagement will incentivize them to limit the threats that portfolio companies might pose to the systems that support overall market returns.

Q: Why should we focus on overall market returns? Isn't our job as fiduciaries to ensure that our active managers are beating the market and that our passive managers are matching it? Isn't that the way to optimize our returns?

A: This describes an alpha-focused strategy, alpha being the term for how your portfolio deviates from the benchmark. The problem is that such a focus ignores the significant influence investors can have on beta—the overall return of the market—which is the largest component of how your actual return differs from the benchmark. Even for actively managed portfolios, the vast majority of your return—some 75-94%—is based on beta, not on the specific securities the asset manager chooses, or how it constructs its portfolio. For passive portfolios, all of the return (other than tracking error) is based upon overall market returns. Investors should consult with counsel with regard to questions concerning fiduciary or other obligations.

Q: But isn't the overall market return a given—shouldn't we focus on alpha (and low fees) in order to optimize the return we get from the market we are presented with?

A: Actually, market return is in large part a function of the health of the financial, environmental and social systems on which the economy relies, as well as the ability of the capital markets to translate economic opportunities and risks into investable opportunities. Asset managers can use their resources to vote shares, engage with companies, and influence public policy to protect and enhance those systems—that's system stewardship.

Q: If asset managers can increase overall market returns with system stewardship, won't they naturally do so, in order to increase their own asset base, and thus their fees? Why do we need to tell them how to do their jobs?

A: This requires a shift in the thought process of many managers. Imagine two situations. In the first, climate change is unabated, and the market is down 5% due to disorder caused by the collapse of the residential insurance market resulting from climate change. In contrast, imagine that investors, companies and regulators worked to lower emissions, limiting climate damage and avoiding the collapse of the insurance market, and that the economy has grown, and the market is up 5%.

Second, imagine two types of asset managers. One does not use resources to mitigate climate risks but beats the market by one percent by overweighting companies that increase short-term profits by dragging their feet on lowering emissions. The second type merely matches the market, putting most of their resources into urging companies to align their emissions with Paris and collaborating with other investors to lobby for effective carbon pricing.

If asset owners focus only on relative performance measures, they will tend to pick the first type of asset manager and companies will not be stewarded to mitigate climate damage. Owners can beat a -5% market by one percent, earning a negative 4% return. In contrast, if asset owners engage in stewardship, more external managers will be encouraged to steward companies towards climate mitigation. These owners will match a market that gains 5%, a much better return than the -4%, market-beating scenario where external managers do not act as system stewards.

Q: Are you saying we should not be choosing external managers based on their relative performance?

A: No, only that it is not the only thing you need to engage them on. Ultimately, security selection is about picking individual companies that a manager thinks will increase in value. Most of the time, that's a good thing, especially when those increases correspond to efficiency and innovation, which also lift the entire economy.

However, some practices that increase company profit can negatively impact overall market returns. For example, a company may save costs by using relatively cheap, carbon-intensive energy, thereby disproportionately contributing to climate change, which threatens the economy's intrinsic value. This occurs because our company's cash flows do not reflect costs that companies impose on important systems. These "externalities" can reduce the value of financial, environmental and social systems, which in turn reduces the general price level of the market.

This is a critical point for understanding the efficacy of system stewardship: the best interests of diversified funds can deviate from the interests of individual companies due to the relationship between company profits, externalized costs, and broad economic performance.

Q: Does this apply to our managers who oversee indexed portfolios?

A: Managers of indexed portfolios generally compete on fees, and this may incentivize them to underinvest in system stewardship, which benefits all diversified managers equally, creating a “free rider” problem. Moreover, many also have actively managed portfolios and may focus their engagement efforts on generating alpha for their own portfolios; others are just not attuned to the issues we’ve described above. In the long run, though, system stewardship that raises value across the market should benefit asset managers as a class: they get paid more if their assets under management increase.

Q: Can you provide another example besides climate?

A: Widespread use of antibiotics in animal agriculture allows producers to reduce the space animals, reducing overall expenses and increasing profits. However, increased use of these drugs accelerates the development of antibiotic resistant bacteria. The UK government estimates the rise of such resistant bacteria will cost the global economy $100 trillion by 2050, as well as cause an incremental 10 million deaths, reducing global GDP by 3-4%. This is a significant risk for the long-term returns of diversified portfolios.

Shareholders have begun to engage companies that sell meat through direct engagement, voting on shareholder proposals, and policy work.

Asset owners should ensure that their external managers are addressing this overall economic concern to protect the long-term prospects of their clients’ diversified portfolios, and not allowing individual companies to profit at the expense of the global health system.

About the Interfaith Center on Corporate Responsibility (ICCR)

The Interfaith Center on Corporate Responsibility (ICCR) is a broad coalition of more than 300 institutional investors collectively representing over $4 trillion in invested capital. ICCR members, a cross-section of faith-based investors, asset managers, pension funds, foundations, and other long-term institutional investors, have over 50 years of experience engaging with companies on environmental, social, and governance (“ESG”) issues that are critical to long-term value creation. ICCR members engage hundreds of corporations annually in an effort to foster greater corporate accountability. Visit our website and follow us on LinkedIn and Bsky.

About The Shareholder Commons

The Shareholder Commons is an independent, non-profit organization that addresses systemic issues from the perspective of shareholders who diversify their investments to optimize risk and return. For more information about our work, visit our website and subscribe to our monthly newsletter.

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