Calvert

Designing an Engagement Strategy Rooted in Financial Materiality

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Industry research to date has largely been focused on improving approaches to integrating environmental, social and governance (ESG) factors into the investment decision-making process. However, far less attention has been paid to integrating financially material ESG factors into approaches for engagement. Engagement has typically been seen as a qualitative accompaniment to data-driven investment decision-making. This is in part because effective engagement, engagement that leads to desired change in company behavior, presents many challenges—even agreeing on the definition of "engagement" can be a difficult task among investors, let alone measuring its effectiveness and the validity of its objectives.

At Calvert, we seek to solve for these challenges by applying the same data-driven financial materiality approach to engagement that we apply to our investment and research processes. Our engagement prioritization and objective-setting processes are informed by the same financial materiality considerations that underpin our investment principles—they are the foundation for our investment products.

This paper reaffirms why engagement is a critical part of responsible investing at Calvert and outlines the challenges of effective engagement—the definition of engagement, integrating engagement into the investment process, measuring the effectiveness of engagement and identifying financially material factors. The paper then discusses an approach to engagement based on financial materiality, which we believe addresses these challenges of engagement.

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The Case for Engagement

ENGAGEMENT IS A NECESSARY COMPONENT OF RESPONSIBLE INVESTING

We believe responsible investment means seeking to understand the challenges facing the world today, ascertaining how companies are positioned to respond to those challenges and allocating capital in a manner that drives positive change and strengthens companies. Engagement in pursuit of improving environmental and social outcomes—as well as long-term shareholder value—is a core component of responsible investing. Calvert maintains a dedicated team of engagement professionals who use our research to uncover financially material opportunities where a change in a company's environmental, social and governance (ESG) approach could help mitigate risk or take advantage of opportunities more effectively.

ENGAGEMENT CAN ENHANCE SHAREHOLDER VALUE …

We believe engagement based on financial materiality, can enhance shareholder value. Studies that cover engagement link the success of engagements to an improvement in company valuations and therefore shareholder returns.[1] At Calvert, we tend to think of engagement as first and foremost about safeguarding and preserving value.

… IF DONE EFFECTIVELY

Best practice in engagement recommends that asset managers explain how they have selected and prioritized engagement with a financial materiality lens, how they have developed well-informed and precise objectives with examples, and reasons for their chosen approach. This presents Calvert and other asset managers with the challenge of designing an engagement strategy that effectively incorporates financial materiality into the process. Despite the need for greater focus on financial materiality in the engagement process, we find a clear gap in the research and existing engagement frameworks to address this need. Our engagement framework, and this paper, attempts to bridge this gap by putting forth a model for effective engagement for asset managers seeking to integrate financially material ESG factors into their engagement process.

Challenges to Effective Engagement

In our experience, there are four key challenges responsible asset managers like ourselves currently face when designing an engagement strategy that effectively incorporates financial materiality. We believe that engagement strategies can benefit from taking into account these challenges.

I. Definition of "engagement"

"Engagement" is typically defined as a purposeful dialogue with a specific objective in mind. Although the definition itself is simple, in our experience the practicalities of operationalizing this definition within the context of asset management are not as straightforward. Asset managers need to balance several factors including their investment time horizons, stated investment principles, duty to underlying stakeholders and regulatory obligations. Some managers classify all company interactions as engagements while others only classify in-depth repeated interactions with a company on a specific issue as an engagement.

Based on our experience and observation, Calvert believes that the way an asset manager defines "engagement" can have an impact on their overall engagement strategy, including decisions such as having a dedicated engagement team or carrying out engagement activities through investment professionals. The definition of "engagement" can also impact the quality and quantity of engagements. Calvert believes that a focused engagement targeting process can lead to better outcomes in the long run and allows asset managers to select and prioritize engagements, enabling them to allocate resources in the most efficient manner.

Ensuring that there is a clear, agreed-upon definition of "engagement" is a helpful starting point for an asset manager when designing their engagement approach, but it is also useful for end clients with sustainable investing preferences looking to hold asset managers accountable and track the results of engagements.

[1] The Investor Forum, "Defining Stewardship and Engagement," April 2019.

II. INTEGRATING ENGAGEMENT WITHIN THE INVESTMENT PROCESS

Calvert believes that engagement is most likely to be effective when it is well integrated with the investment process – a consideration where stewardship and investment teams are separate. Individuals conducting engagements should seek to ensure information sharing with those responsible for investment decision-making and vice versa. For example, engagers may meet regularly with active portfolio management teams to discuss progress on objectives and understanding how investment rationales may impact a target company. Additionally, to ensure that engagement topics are financially material, individuals conducting engagements should have a deep understanding of the portfolio manager's company-level responsible investment.

Asset managers striving to integrate engagement within the investment process may find it challenging to do so in a repeatable and scalable manner. This can be especially difficult where the stewardship team is separate from the investment team because different messages coming from the same asset manager may weaken engagement efforts. Calvert believes that an engagement approach focused on financially material ESG factors helps bridge potential gaps between these two groups whether they are on the same team or different teams. When engagements are focused on financially material issues, determined using a clear, agreed-upon methodology, communication between stewardship professionals and investment teams is often improved.

III. MEASURING THE EFFECTIVENESS OF ENGAGEMENT

Share price is not an ideal barometer for engagement success due to the influence from a multitude of factors not related to the engagement issues including broader macro events and drivers. We believe engagement success is better measured by the extent to which company interactions result in the achievement of predefined objectives or behavior changes. Choosing the right objectives also increases the likelihood of engagement success. At Calvert, a well-defined engagement strategy where success can be measured, allows us to demonstrate value to our clients and portfolio companies.

IV. IDENTIFYING FINANCIALLY MATERIAL ISSUES

Calvert believes that an engagement plan rooted in financial materiality is more likely to result in company behavior change because companies are more likely to respond to engagement on financially material ESG factors.

Accurately identifying financially material ESG factors for each company can be an intimidating task for an asset manager with thousands of holdings and limited staffing resources. Nonetheless, this is a crucial first step in selecting and prioritizing engagements.

The Calvert Approach to Financial Materiality

Calvert's approach for determining if an ESG risk or opportunity is financially material is based on identifying a demonstrated link or likely future link between that risk or opportunity and three key drivers of a firm's value: operational impact, regulatory risk and reputational impact. The impact of the key drivers of a firm's value are then tied back to company's financials, i.e., revenues, expenses, and the cost of capital. Calvert's proprietary research based on this approach to financial materiality, is incorporated into the investment decisions made across Calvert's investment strategies and the engagement strategy.

An Engagement Approach Rooted in Financial Materiality

To address the engagement challenges outlined earlier, this section discusses a possible methodology for designing an engagement strategy that aims to maximize impact and is rooted in financial materiality. This approach utilizes concepts from Calvert's research process for illustrative purposes. For a holistic view of Calvert's overall approach to engagement, please reference our Tools of Change report available on calvert.com. Our forthcoming Stewardship Report will provide additional detail on our approach to engagement.

STEP 1 – SCORE FINANCIALLY MATERIAL ESG FACTORS

Our proprietary research model scores each company on all identified ESG factors for the peer group. All factors are assigned a weighting based on their potential impact to the long-term value creation of the company. These weightings and factors are the same for the whole peer group, but the company scores differ depending on their performance on these ESG factors. The data from the model is used to assign a score based on the relevance of each ESG factor for each company.

In step 1, each company is scored on two verticals. The first score represents how financially material a topic is as defined by the weighting of the ESG factor in Calvert's research models. The second represents the individual performance of the company on the ESG factor, relative to the peer group. We call the first score the issue relevance and second score the management gap. The management gap shows the company's ability to improve, to match the best-performing peer on a given ESG factor. The issue relevance shows how important a given ESG issue is for the company relative to other issues. Calvert believes that engagement is often effective when the objective is to bring a laggard company up to the standard of an industry leader.

The interaction of the management gap and issue relevance is used to assign each ESG factor a score (on a scale of 0 – 5), allowing for the identification of the most financially material factors. Factors that score a 3 or above are considered eligible for engagement. According to our model, these are the areas where the company has the most ability to improve, relative to the peer group.

STEP 2 – WEIGHT FACTORS ACCORDING TO HOLDING SIZE

One the areas for engagement for each company have been identified, they are then weighted based on the holding size of the company in the portfolio.

This is done by multiplying by the holding weight of the company in the whole portfolio by the score assigned to the factor in step 1. This results in a weighted factor level score for each company. As factors that score below a 3 are deprioritized from an engagement perspective, the weighted score here shows up as 0. This is done to ensure that several less material issues do not add up and push a company further up the prioritization in the next step.

Display 1: Methodology Overview

SCOPE OF ANALYSIS	STEP		METHODOLOGY
Factor	1	**SCORE** Financially Material ESG Factors	Factors scored based on management gap and issue relevance
Company	2	**WEIGHT** Factors According to Holding Size	Factor scores multiplied by holding size
Portfolio	3	**RANK** Companies with a Portfolio	Company level scores aggregated and ranked within a portfolio
	4	**REFINE** Portfolio Level Target List	Qualitative review of ranked list to define engagement objectives for eachtarget company

This represents how Calvert generally implements its process under normal market conditions.

Once step 2 is run for all companies, the final focus list can be tweaked to ensure coverage across all strategies if needed and as appropriate.

STEP 3 – RANK COMPANIES WITHIN A PORTFOLIO

The weighted scores calculated in step 2 at the factor level are aggregated for each company to give a final aggregated score. These aggregated scores are used to rank the companies in order of priority for engagement, and all the identified financially material factors are listed as material engagement issues from which objectives can be further defined.

Companies that are larger holding in the portfolio with poor performance on several financially material ESG factors relative to peers, are likely to be at the top of the list and therefore the highest-priority engagement targets.

STEP 4 – REFINE PORTFOLIO LEVEL TARGET LIST

In order to ascertain the specific risks and opportunities under each ESG factor, the Calvert engagement team, in coordination with the investment teams and the Calvert research team, runs a qualitative review on the list developed in step 3 to ensure the scores are an accurate depiction of company performance. This process is also used to prioritize engagements with a higher likelihood of success–engagements on issues where management teams have greater control and opportunity to improve. This review allows the team to define specific areas of engagement within the broad identified area and develop objectives accordingly.

An example is shown for Company A in *Display 2* where the analysis identified three material ESG factors for engagement (Privacy & Data Security, Corporate Ethics & Behavior, Pollution & Waste). Following the collaborative review process, Privacy & Data Security was identified as the area where engagement could add most value and work with the company to improve their performance.

This methodology prioritizes holdings in the portfolio, allowing Calvert to maximize our engagement impact. Improving the performance of a financially material ESG factor at a given company through engagement may result in a positive financial return. Ongoing dialogue between our engagement and investment teams can lead to better engagement and investment decisions effectively integrating ESG across the value chain.

Display 2: Qualitative Review of Factors to Determine Objectives

CALVERT PORTFOLIO	RELEVANT ESG FACTORS
COMPANY NAME	**LIST OF MATERIAL ESG FACTORS FOR ENGAGEMENT**
Company A	E | Pollution & Waste G | Corporate Ethics & Behavior S | Privacy & Data Security

- **Stewardship Team:** This company has been involved in various data breaches, harming its reputation in some markets. Ensuring robust risk mechanisms is crucial to avoid further reputation and financial damages.
- **Portfolio Manager:** The data breach risk has been a significant drag to valuation, and we would like to see changes to ensure this is not an issue in the future
- **Research Analyst:** This company lags peers in their risk management and has seen a number of fines related to this. They handle mass amounts of data, which could also pose a regulatory risk if they don’t shore up risk management in this area.

Conclusion

The Calvert approach laid out in this paper addresses key challenges that an asset manager may face when designing an effective engagement strategy appropriate for the purpose of risk mitigation and value preservation. Some of the benefits of this approach are summarized below.

- It is rooted in financial materiality, which makes engagement objectives more meaningful and more likely to be achieved. It also seeks to deliver long-term value to clients through real-world impact and preservation of value.
- Data from our proprietary research model allows for a customized approach, ensuring that financial materiality is a true reflection of our investment principles. This also allows for efficient integration of engagement and investment activities.
- The framework provides flexibility to adjust the scope of the engagement strategy based on various considerations. Prioritization of companies allows for focus on the most significant holdings with financially material issues. This maximizes the impact of our engagement activities.
- The focus list can be further qualified through additional stakeholder input, including factoring in client preferences for engagement issues where appropriate. Likelihood of engagement success can also be layered in as factor to maximize impact.

Risk Considerations

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with investments in foreign developed countries. ESG strategies that incorporate impact investing and/or **environmental, social and governance (ESG)** factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required.

For important information about the investment managers, please refer to Form ADV Part 2.

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