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LGIM's ESG scores

A quantitative analysis of the impact of our engagement campaign

Legal & General
INVESTMENT MANAGEMENT

In 2019, LGIM ran a targeted engagement campaign focused on social, governance and transparency issues at large companies with poor ESG scores. After giving them an opportunity to improve their scores, we take a quantitative look at the results in this paper to identify whether progress has been made.

LGIM's purpose is "to create a better future through responsible investing". We have always been clear that one of the primary ways in which we can achieve this is through our stewardship activities – using our influence as a major institutional investor, both through voting with the shares we own and through collaboration with peers and policymakers to raise overall standards in the market.

In 2020, for example, we voted at 14,288 company meetings.[1] We also held 891 engagements with companies to raise their environmental, social and governance (ESG) standards. We therefore feel confident in describing ourselves as active owners. But are we effective owners?

1. Source: LGIM, February 2021

It's a question our clients and other stakeholders rightly often ask us: "How do you measure the success of your engagements?" Our quarterly impact reports and our annual Active Ownership report provide plenty of qualitative evidence of the results we achieve through engagement. This campaign based on ESG scores, though, is an opportunity for us to look more closely at the impact of our engagement using data only. In this way, we can measure the evolution of our scores over a one-year period to understand if the companies we engaged with have listened and improved their scores.

We are committed to being transparent about the observed results of this campaign and to providing our clients and other stakeholders with an honest assessment. We believe doing so can help us not only be more transparent with our clients and stakeholders, but can moreover help us refine our approach and engage more purposefully in the future.

This article therefore details the effect the engagement campaign we undertook in 2019 had over the following year on the companies we targeted. Importantly, we are looking solely at changes in the ESG scores of these companies between September 2019 and September 2020; these scores are based on data from independent third-party providers. Our scores and methodology are fully transparent and publicly available through our dedicated website.

Marion Plouhinec
Senior Global ESG Analyst,
Investment Stewardship

Clare Payn
Senior Global ESG & Diversity Manager,
Investment Stewardship

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S, G & T time

In 2019, we selected 124 companies for targeted engagement on one or more of their social (S), governance (G), and transparency (T) scores, each of which feeds into our overall ESG score. The companies we chose to engage in this campaign were identified on the basis of both their size and prominence in our equity and fixed income strategies, and their low S, G, and/or T scores.

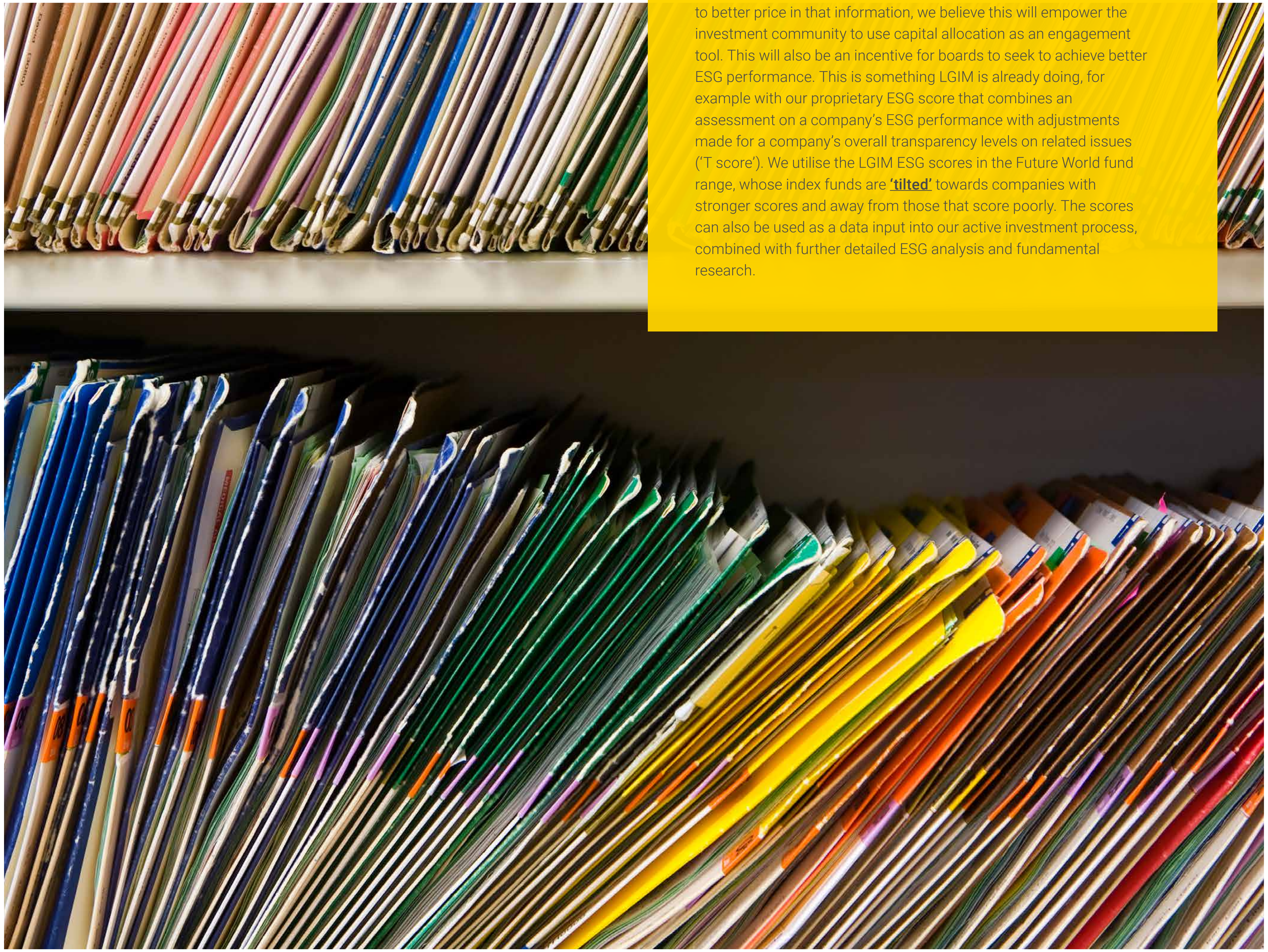
These were primarily educational engagements, rather than traditional active owner conversations. Our dialogue with the companies therefore had three broad aims:

- To highlight their poor ESG scores to the laggards in which we have significant stakes;
- To create awareness at board level around ESG scores, their use in capital allocation (see box), and the importance of verifying third-party ESG data;
- To emphasise our commitment to transparency.

However, we acknowledge that change cannot happen overnight. This is particularly true for some of the criteria that determine our ESG scores. For example, while we may reasonably expect relatively swift action to address shortcomings on our transparency indicators through enhanced disclosures, we appreciate that it can take longer within a company to change a social or governance metric. Appointing a new director to strengthen diversity on the board may take more than a year, for instance. We must also take into account the time needed for third-party providers to reflect changes within their databases.

ESG scores and capital allocation

As more widespread access to ESG data gradually enables markets to better price in that information, we believe this will empower the investment community to use capital allocation as an engagement tool. This will also be an incentive for boards to seek to achieve better ESG performance. This is something LGIM is already doing, for example with our proprietary ESG score that combines an assessment on a company's ESG performance with adjustments made for a company's overall transparency levels on related issues ('T score'). We utilise the LGIM ESG scores in the Future World fund range, whose index funds are **'tilted'** towards companies with stronger scores and away from those that score poorly. The scores can also be used as a data input into our active investment process, combined with further detailed ESG analysis and fundamental research.



Progress made...

So, with that context, did the score of the companies we engaged with improve following our campaign?

Percentage of companies whose scores improved from 30/09/2019 to 30/09/2020

Campaign / score	ESG	E	S	G	T
S Campaign	72%	64%	62%	47%	77%
G Campaign	67%	51%	42%	71%	78%
T Campaign	59%	69%	44%	50%	53%
Overall	**68%**	**60%**	**52%**	**58%**	**73%**

Source: LGIM, as at February 2021

A few messages stand out to us:

- Across each of our campaigns, we have seen progress at around two-thirds of the companies targeted. Moreover, the magnitude of improvement in both the total ESG scores and their individual components has been significant.
- More encouragingly, we did witness something of a halo effect: when we engaged companies on a single topic, there tended to be an associated improvement in their individual scores and wider ESG score. For example, we saw 72% of companies targeted on 'S' improve their overall ESG score, and 77% of S-targeted companies improve their 'T' score.
- We note a 67% improvement of ESG score and 78% improvement of T score for the G-targeted companies. Lastly, there is a lower but still meaningful 59% ESG score improvement for the companies where we focused on T.

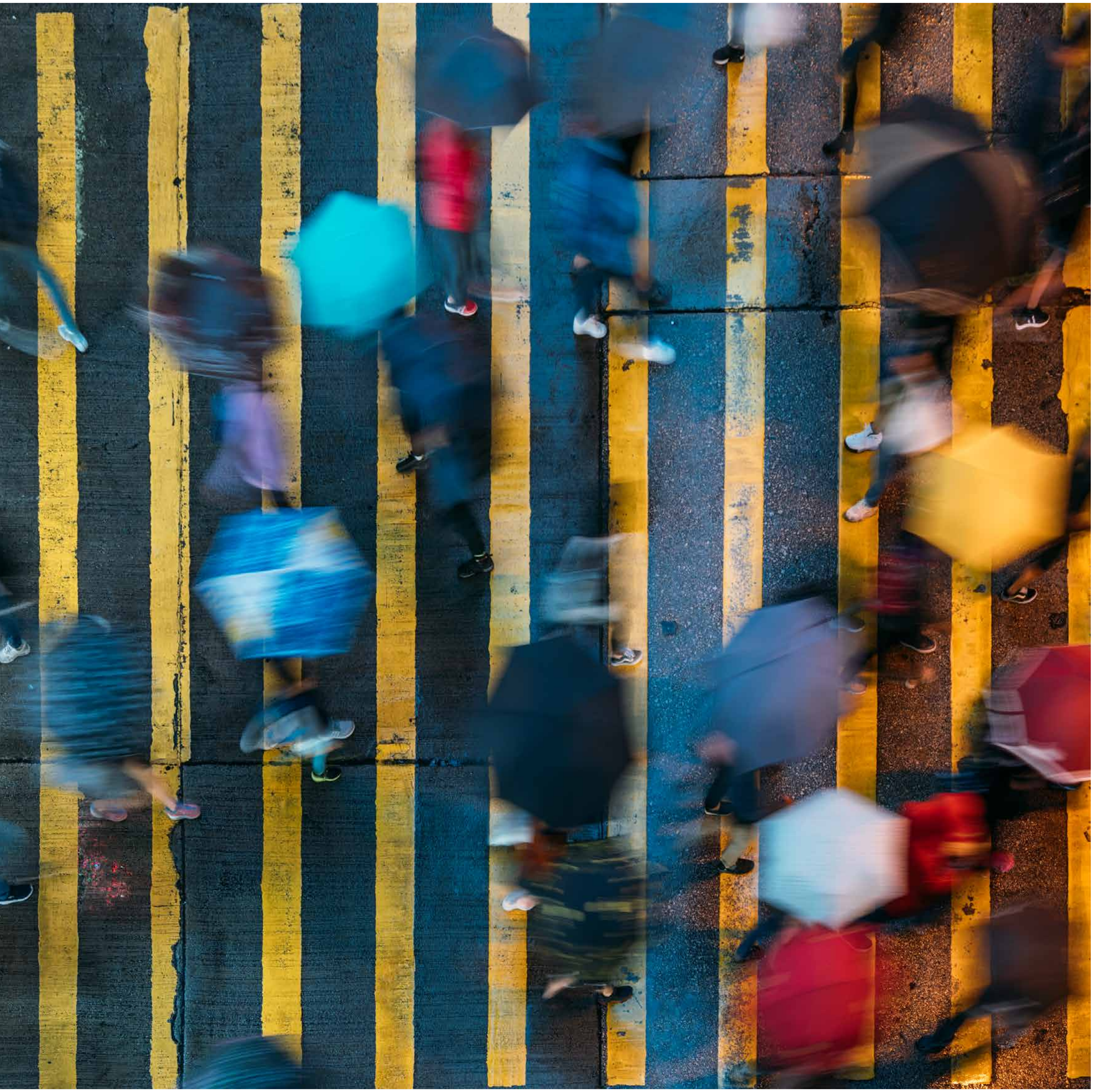
...but we can go further

This is of course what we hoped to see, but we must also note some more disappointing trends. One concern is the response to engagement on transparency. As this relates to minimum levels of disclosure, it should be relatively straightforward for companies to remedy. However, this was the campaign that delivered the least success: only a little more than half of these companies recorded any progress on their ESG score and only 53% of companies targeted on transparency improved their T score.

There are some caveats: there will be a lag effect both as companies put in place new policies and as these are recognised by the data providers; and it may be that companies that lack transparency in the first place are the hardest to engage on ESG matters.

Because transparency is absolutely essential – investors need access to relevant, comparable, consistent, and verifiable ESG data across markets regardless of size, geography or asset class – this will be a priority for us. **From 2022, LGIM will therefore be voting against any laggards on our T score.** This means that any company not providing sufficient disclosure on the following indicators will be sanctioned:

- ESG reporting standard
- Verification of ESG reporting
- Scope of greenhouse gas (GHG) emissions
- Tax disclosure
- Director disclosure
- Remuneration disclosure



Inaction is not an option

While two-thirds of the companies we engaged with improved their overall ESG score, this also means that a third of companies received a worse ESG score a year after our engagement.

We will keep engaging with the companies in which we invest in order to raise standards across the market for the benefit of all our clients and stakeholders. This analysis only reinforces our commitment to such active ownership, and will help us refine our approach to maximise our impact.

Investors' and the public's expectations on social, governance, and transparency considerations are only going to grow, so we encourage companies to take these issues seriously. We believe those with the weakest ESG profiles are likely to be penalised by the markets and it is therefore critical that boards are proactive, decisive, and follow through both to implement at least the minimum standards and to ensure the information third-party ESG data providers have is accurate.

Given the importance of ESG scores and their impact on capital allocation, we expect all companies to seek to position themselves as ESG leaders and understand the centrality of transparent disclosure and data verification. Our engagement campaigns are designed with the aim of helping them achieve this and, based on the insights from quantitative and qualitative analysis of our work, we look forward to further progress in 2021 and beyond.

Spotlight on Asia excluding Japan

As part of this campaign, we engaged 17 companies based in the Asia ex-Japan region (spanning Australia, China, Hong Kong, India, Korea, Singapore, and Taiwan). Overall, 10 of the companies targeted (59%) improved their total ESG score. Five of the nine companies we engaged specifically on transparency (companies could be engaged on more than one area) improved their T scores – including one that climbed from zero – and none deteriorated. Encouragingly, we also observed a halo effect on transparency as seven of the other eight companies we engaged only on social and/or governance issues increased their T score too, by an impressive average of 31%. Five of the eight companies targeted on governance improved their G scores. Of the four companies where we focused on social metrics, only one improved its S score, but we recognise that it takes time to address some of the points we raised in this area.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Legal & General Investment Management Asia Limited, Unit 5111-12, Level 51, The Center, 99 Queen’s Road Central, Central, Hong Kong.
www.lgim.com

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