Research spotlight

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Shareholder engagement and its effects on target companies

The award-winning study 'ESG shareholder engagement and downside risk', which uses engagement data from Hermes EOS, reveals that companies that are successfully engaged by EOS exhibit a lower risk profile, particularly when environmental issues are tackled. The study adds to the increasing literature on stewardship, and demonstrates that there are direct financial benefits for investors when engagement occurs at the right level and with the appropriate resources. The authors won the 2019 PRI award for the best research in responsible investment.

In recent years an increasing number of academic studies have looked at institutional investors engaging with companies through private, behind-the-scenes dialogues and other means.[1] However, scepticism remains amongst practitioners as to the financial benefits that may accrue from dedicating significant resources to stewardship.

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A few years ago, Hermes EOS shared its engagement data with an international team[2] around Professor Andreas Hoepner from University College Dublin. The authors formulated a very simple – in this case paraphrased – research question: What effect do engagements by Hermes EOS have on the riskiness of targeted companies?

This relatively straightforward question rests on the theoretical concept that shareholder engagement, when conducted effectively and targeting the financially most material ESG issues to which a company is exposed, should reduce that company's level of risk. Companies with better ESG credentials have on average a lower chance of going bankrupt, more stable cash flows, and are more resilient to external ESG shocks, such as tightened regulation on pollution and climate change[3]. The financial benefits of better ESG practices for bond investors have also been proven.[4]

The approach taken by the academics has similarities with medical research. For example, to test the effectiveness of a new drug, researchers typically investigate two different groups of patients. There is a 'treatment group' of patients, all of whom receive the new drug, and a 'control group' who receive a placebo but are otherwise exposed to the same medical and personal conditions, such as age, weight and so on. In other words, the two groups generally only differ regarding one characteristic – whether they receive the drug or not.

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[1] See, for example, McCahery, Sautner and Starks (2016): "Behind the Scenes: The Corporate Governance Preferences of Institutional Investors", Journal of Finance, 71(6), 2905-2932.; Krueger, Sautner and Starks, (2019): "The Importance of Climate Risks for Institutional Investors", ECGI Working Paper; Dimson, Karakas, and Li, (2016): "Active Ownership", The Review of Financial Studies, 28(12), 3255-3268; Becht, Franks and Wagner, (2019), "Corporate Governance Through Voice and Exit", ECGI Working Paper.

[2] The research team also includes: Ioannis Oikonomou (Henley Business School), Zacharias Sautner (Frankfurt School of Finance and Management), Laura Starks (University of Texas at Austin), and Xiao Zhou (University of Oxford).

[3] See, for example, Clark, Feiner, and Viehs, (2015): "From the Stockholder to the Stakeholder", Working Paper, as well as Friede, Bassen, and Busch, (2015): "ESG and financial performance: aggregated evidence from more than 2000 empirical studies", Journal of Sustainable Finance and Investment, 5(4), 210-233.

[4] An example in the academic literature serves Chava (2014): "Environmental Externalities and Cost of Capital", Management Science, 60(9), 2111-2380. Further practitioner examples are the research studies by Hermes Investment Management: "Pricing ESG risks in credit markets" and "Pricing ESG risk in sovereign credit" which are available at www.hermes-investment.com.

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Putting this example into the context of engagement, the study's authors constructed a treatment group of companies – those that had been targeted by EOS – and a control group – those that had not been targeted by EOS. In all other characteristics, such as size, industry and profitability, the companies in the control group were the same as, or very similar to, those in the treatment group. As in the medical example, there is only one distinguishing feature in the two samples – the presence of EOS's engagement. This allowed the researchers to draw strong conclusions about the effect of engagement by EOS on target companies.

The authors used two measures as proxies for company risk. The first was a risk-weighted probability of a negative stock return occurring on any given day in a given month, and the second was the value at risk (VaR) – that is, the worst daily returns during a given month. As in medical studies, which test the efficacy of drugs pre- and post-treatment, the authors then tested the riskiness of companies pre- and post-engagement.

The results from this exercise showed that the companies targeted by Hermes EOS experienced a significant decline in their riskiness after the engagement versus before, all relative to a control group of companies that had not been targeted for engagement.

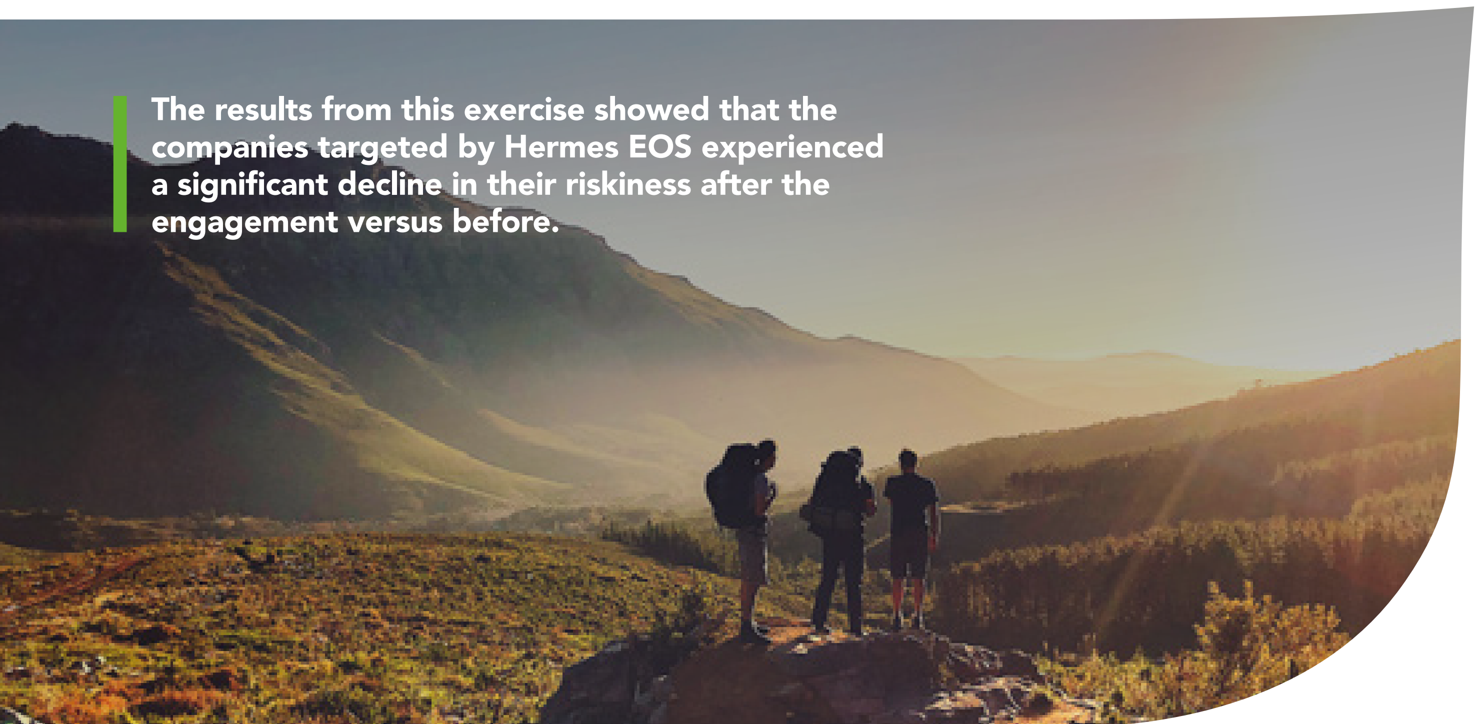
Putting this result into the context of the Hermes EOS milestone system, which tracks engagement progress, the authors were able to document that the risk reduction effect from engagement is largest when the engagement is more successful – that is, the engagement stands at milestone 3 or 4 – and when environmental topics are addressed.

The authors of the paper also found that the vast majority of interactions by the EOS team took place in the form of a personal meeting, be it with a company chair, a senior executive or middle management. The more successful engagements often involved an interpersonal communication with a chair or senior executives.

This finding reinforces the conclusions made by the research team around Professor Wolff who documented this relationship in 2017, identifying a link between the engagement success of Hermes EOS and interpersonal communication. In the independent study "Talk is not cheap", he and his research team demonstrated that EOS's interaction with chairs and executives was the most important factor when seeking to promote change at companies.

Overall, the research carried out with Hermes EOS engagement data provides evidence that stewardship can result in material financial outcomes for companies and their investors. However, it is important to understand that several prerequisites must be met in order to achieve change.

A constructive dialogue with companies at a senior level is most effective in promoting change and financial benefits. Equally important to note is that such a dialogue requires resources, knowledge, seniority, and a multi-skilled team. To promote long-term value, effective stewardship must be more than just a letter-writing exercise.



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Case studies are shown to demonstrate engagement, EOS does not make any investment recommendations and the information is not an offer to buy or sell securities.

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