Asset

Promoting sustainability and transparency through corporate engagement

Introduction

Engaging with investees is a good practice adopted by asset managers and considered increasingly important in the investment industry around the world.

Through engagement, investors can actively interact with investees and aim to influence decision-making and promote improvement in material topics such as corporate governance, environmental performance, and relationship with stakeholders.

Its origin can be traced back to early in the 20th century when investors began to exercise their rights and seek to influence the companies in which they were invested. Over time, this activity has evolved and consolidated a larger group of investors willing to act proactively with companies under different engagement models over a range of themes.

Initial main topics addressed by investors related to corporate governance and internal management practices of companies. In the 1960s and 1970s, socially responsible investments became a significant topic, leading managers to include ethical and social related topics in their engagement actions.

This development has contributed to start off the integration of environmental and social issues into the engagement process. In the 1980s and 1990s, managers in developed countries began to engage more actively with companies over matters such as compensation, environmental impact, and human rights.

Early in the 2000s, a more systematic approach gained relevance, contributing to the emergence of the ESG engagement. Investors who began to include ESG topics in their investment processes started to recognize the importance of sustainability and responsible business practices in the creation of long-term value.

A major step in this stage was the shift from a reactive to a proactive engagement approach, emphasizing the importance of creating value in the long term, by evolving the sustainability topic in investments in addition to being an adequate way to promote more accountability, i.e., transparency and responsibility.

With the development of this engagement strategy alongside its adoption by a growing number of managers and investors, we now have different strategies for outcomes´ management and even the exclusion of companies depending on the engagement success or failure.

Unsuccessful engagement can influence investors to reduce their positions, vote against a certain item at stockholders' meetings or even, in more extreme cases, exclude the company from their investment portfolio.

Operation of Itaú Asset Management

Our purpose is to help clients achieve their long-term financial goals, contributing to the development of sustainability in investments through t our platform of products and services.

We believe that engaging with investees is a proper way to improve our understanding of these companies and promote better ESG practices. The purpose is to create a constructive dialogue and deepen the understanding of how certain ESG issues may affect the company's market value and its stakeholders. (Itaú Asset Management's Sustainable Investment Policy)

Engagement has a key role in the investees' adoption of best practices. Through the active participation in individual or collective engagement, investors can influence corporate performance, promote best practices and encourage initiatives that prioritize strategic themes such as biodiversity conservation, robust corporate governance practices and better relationship with stakeholders.

We believe that good management of environmental, social and corporate governance factors are key drivers of long-term performance for our investees, whether due to opportunities or risk mitigation

Monitoring the robustness of corporate sustainability practices and excellence in management of our investees is essential to create value and develop more transparent and efficient financial and capital markets.

Our Sustainable Investment Policy presents our engagement approach with investees for active and passive investments.

Engagement is carried out through interactions and dialogue between investors and current or potential investees with the following main objectives:

- encourage the adoption of the best management and governance practices
- influence sustainability-focused policies and practices
- discuss ESG risks and opportunities
- promote transparency and disclosure of material ESG information
- deepen the understanding of certain environmental, social and governance issues that may impact the value of companies

Materiality and engagement topics

Determining topics for engagement is a challenge for most investors. Different sectors can generate different environmental and social externalities.

During this process, investors can consider several factors to ensure the engagement is aligned with the investees' ESG risks and opportunities as well as with the investors´ principles and goals as investors.

A key step is the materiality analysis, aimed to identify the main environmental, social and corporate governance topics that are material to investees when it comes to risks and opportunities. Taking into consideration topics such as new regulations, market trends and sustainability challenges may be part of this process.

The SASB materiality map is a positive contribution, as it identifies the most material ESG topics by sector of activity of the companies. Additionally, factors such as business models, value chain and relationships with different stakeholders may also be key drivers.

The prioritization of topics with the greatest impact on the creation of economic value and long-term sustainability performance is an approach adopted by many investors.

We describe below the main topics assessed and monitored by Itaú Asset Management's ESG team which can start off the interaction or engagement process, either prior to or after the investment.

environmental

climate change

- carbon pricing
- physical damage to company's assets
- change in water cycles
- impacts on agricultural and forestry production
- new products linked to a low-carbon economy

biodiversity and land use

- impacts on biodiversity
- bioinvasion
- soil and water contamination
- animal welfare
- conversion of native vegetation

water, energy and materials

- water scarcity
- use of sustainable inputs
- eco-efficiency initiatives
- renewable energy
- charge for water use

waste management

- waste and effluent management
- emission of pollutants
- reverse logistics
- waste reuse
- recycling revenue

social

relationships with clients

- data protection
- quality and safety of products and services
- sustainable products
- false advertising
- charging clients abusive or undue fees

relationships with suppliers

- human rights
- working conditions
- outsourcing
- deforestation
- sustainable inputs

relationships with employees

- human rights
- health and safety
- strikes and stoppages
- talent turnover and retention

relationships with communities

- conflicts with communities
- land issues
- management of stakeholders
- building in unregulated land
- community safety and security

Governance

Board independence and quality

- CEO duality (the practice of a single individual serving as both CEO and Board chair)
- independent members
- non-executive members

Corporate governance

- Board diversity
- compensation
- committees

Engagement is key in the ESG journey

Over the last few years, climate change has become a common topic in the interaction agendas among asset managers, investors, and companies. Climate change has the potential to increase the frequency and severity of extreme climate events, alter rainfall patterns, affect agroforestry productivity, and demand massive investments so that companies can adapt and become resilient to climate change impacts.

However, how can companies prepare to deal with topics such as carbon pricing and climate resilience? This question, which did not used to be a part of investors, companies and asset managers´ reality, due to their potential impact, are now closely monitored, reinforcing the need for a more technical dialogue.

The climate agenda has become more important on asset managers´ agenda who face a more challenging scenario, turning to investees to understand how they have been impacted and what have their executives done in their strategic plan to prepare for this new reality. Furthermore, the maturity that investors are gaining on the topic reinforces the need for this dialogue.

This type of interaction with companies is called engagement. Asset managers engaging with investees to promote best practices is nothing new, but it is as the focus of something dynamic, making climate change becoming an increasingly recurring topic in these meetings and in other items of the 2030 Agenda.

Some asset managers engage with companies individually, seeking specific information on topics of their interest and using their position as investors to promote best practices such as transparency, environmental and social management, and corporate governance.

Individual engagement is the most common one among asset managers. However, as they often hold a relatively small stake in companies, this form of engagement can have limited success when it comes to the measures companies are expected to adopt.

Since individual efforts do not always have the expected effects, asset managers started to organize themselves collectively to engage with companies on certain specific topics. We refer to these as collective engagements, in which two or more entities jointly aim, via letters or meetings with executives or advisors, to promote positive changes in a company's practices. This is the start of a constructive dialogue to achieve concrete measures to direct actions pragmatically about issues under discussion.

A positive example of collective engagement by Brazilian asset managers is the IPC (Investors for Climate) initiative. IPC was launched in 2019 and currently has more than 40 local investors with over R$2 trillion under management. One of its goals is to encourage investees to be more transparent when it comes to climate change risks and opportunities.

It is clear that individual and collective engagement are important, as they establish a dialogue aimed to align companies' strategic planning towards the continuity of its operations by mapping risks and opportunities in addition to those identified by a traditional financial analysis, such as those related to climate change.

Meanwhile, they helps asset managers to address a complex challenge: having a consolidated view of climate risk of their portfolios. To this purpose there are proposals and models for this type of assessment, an area still with a great potential for development.

Therefore, we can observe that the financial and capital markets play a vital role when it comes to climate change, mainly due to their ability to promote best ESG practices. This role makes the investment industry more accountable as asset managers need to develop ways to integrate these climate scenarios in their assessment and investment decision-making process, in addition to demanding more transparency from companies.

As the agenda of investors, companies, and asset managers moves forward together, we will be able to see a positive context that will contribute to reducing the climate risk of portfolios and to advance the path towards achieving the global goals of the Paris Agreement and the 2030 Agenda.

Examples in practice

1. Biodiversity, risk management and relationship with stakeholders

To illustrate our engagement journey, we have an ESG engagement process in which Itaú Asset Management jointly led a group of over 100 local and international investors in a project with a mining company in 2019, with a focus on risk management, ESG opportunities and sustainable performance. Overall, more than 10 talks and interactions took place over three years, addressing topics such as health and safety, relationships with communities, social and environmental impacts, ESG practices and corporate governance. This process is still in progress with the company changing some of its practices, committing to improving internal processes and having greater transparency in reporting to investors.

2. Corporate Governance

In 2023, in the process of assessing a fixed income investment in a privately held company, we identified the opportunity to improve its corporate governance´s structure and practices. After engagement meetings with executives and controlling stockholders, Itaú Asset Management submitted a proposal for an action plan for the company.
This proposal was aimed to promote the independence of the board of directors and set up audit and compliance structures as follows:

1. 30% of independent members
2. set up of an audit committee and a Compliance-dedicated team.
3. limit CEO duality (the practice of a single individual serving as both CEO and board chair)

In addition to the company's commitment to following the plan submitted, these obligations were formally included in the issuer's obligations in the related document. This type of obligation or covenant is not often adopted in the market yet, although it has the potential to ensure greater alignment between management members and investors.

Examples in practice

3. Engaging service providers:

The engagement by investors is not restricted to investees. In many cases, service providers contribute significantly with analyses and information about the ESG performance of investees.

We use service providers in our voting activities at investees stockholders’ meetings. The voting decision is independent and subject exclusively to internal governance.
These service providers must necessarily incorporate ESG issues into their activities and recommendations.

However, there are cases where this information may not represent the investor's or market's perception of the company. In these cases, engaging the company is followed by engaging service providers to obtain clarification and promote better alignment between the company's practices and its assessment by service providers.

Conclusion: direction we seek for companies

Investors are increasingly able to influence companies and promote a wider adoption of ESG best practices. Engagement strategies significantly add to ESG assessment and integration processes, and positively contribute to the fulfillment of the fiduciary duty of investors and asset owners.

Engagement practices and topics continue to evolve at an accelerated pace. The emergence of new topics and standards aim to align the needs of companies and of investors in a world that increasingly seeks greater accountability.

As engagement strategies become more widespread, we can expect a greater value creation for companies, investors, the environment, and society. Managers observant of this trend can mitigate risks and leverage the positive impact of their portfolios.

In addition to engaging with our investees, service providers, clients, and civil society, we believe that the creation of learning content on significant topics also contributes positively to their development.

As more asset managers, investors and market participants start to adopt ESG engagement strategies, we will be able to leverage the creation of shared value beyond investment portfolios.

Companies that are more responsible, transparent and mindful to their stakeholders' demands are able to generate profits from environmental, social and economic sustainability for present and future generations.

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