Marketing Material

Corporate governance – the added value of good corporate management

Governance risks and opportunities should be an integral part of an asset manager's investment process and should go well beyond the fiduciary duty of exercising voting rights. Regular review and active dialogue with the companies one invests in are mandatory.

Dennis Haensel, Global Head of ESG Investment Solutions and ESG Advisory, interviews Nezhla Mehmed and Hendrik Schmidt, DWS's experts in corporate governance, and asks them to explain DWS's priorities and how they engage with the companies in which we invest.

Q: Dennis: Nezhla, how do we define corporate governance in our company?

NEZHLA As the G in ESG, corporate governance is one of the most important factors as it is the foundation of the long-term and sustainable corporate development of a company. For us governance is actually the basis for both the Environmental and Social parts of ESG. We strongly believe that companies who have sound governance tend to experience fewer problems with environmental and social issues, and therefore present less risk to investors. We are also convinced that good governance is key for higher relative stock returns in the long term. There's strong academic evidence that good governance can positively influence company valuations and investment performance.

Q: Dennis: Looking back, how long has DWS taken a sophisticated approach to governance?

NEZHLA DWS has been looking at corporate governance for a very long time. For us it has always been an important part of the investment process, going well beyond the fiduciary duty of exercising voting rights. For example, the first Annual General Meeting in Germany that we attended, and at which we gave a shareholder speech, was back in 1994. At that time, it was quite revolutionary, I would say, for shareholders to explain their criticisms directly and openly to the Management and Supervisory Boards.

Q: Dennis: Hendrik, you are the responsible DWS expert for the German market and regularly represent our interests to boards of directors and supervisory boards and also at annual general meetings. What exactly are our corporate governance requirements?

HENDRIK We have based our understanding of corporate governance on four main pillars, or cornerstones.

1. The first is the composition of the Supervisory Board: we look at qualification and competence, independence, diversity, experience – in other words, a very broad spectrum of characteristics that should ensure an adequate representation of our interests.

2. This is supplemented by the remuneration system for the leaders of a company, i.e. primarily for the Board of Management, which transparently shows which elements of the corporate strategy are actually part of the motivation of the Board of Management as a guide for bonuses. We now also expect this for non- or extra-financial targets, which are also set out in the corporate strategy – to see that these are not just empty words or pretty marketing brochures but are actually in the interests of the Board of Management.

3. The third pillar is the external view: the audit certificate and the opinion of the auditors. This is a very important confirmation that the company's reporting and its accounts are correct. We have to rely on this, but also require a certain degree of transparency i.e. with regard to fees for consulting services, the term of appointment and the name of the lead audit partner.

4. And finally: the treatment of shareholders' rights. The Covid-19 pandemic has significantly restricted them – not only in Germany but also across other jurisdictions – with regard to, for example, the conduct of AGMs and the ability for shareholders to fully exercise their rights. We clearly expect these shareholder rights to be re-established. Going forward, shareholders will provide legitimacy for boards and companies even more. Just as an example, from 2021 onwards shareholders will have a regular say on pay across all EU-listed companies. But also when it comes to structural measures, i.e. when you massively change the risk profile of a company through acquisitions, then we also expect that we as owners are given a certain say. We also expect more and more shareholder resolutions to be put up for vote concerning specifically the sustainability performance of companies.

Q: Dennis: Nezhla, could you describe for us the next steps?

NEZHLA To really start from the beginning, our Active Ownership activities, including the exercise of voting rights and engagement with investees, are applied to all of our mutual and special funds as part of the investment process and our fiduciary duty as an asset manager. Our institutional clients also have the option to proactively hand over to us discretion to exercise the voting rights of the mandate, in which case they can also benefit from our approach.

> Governance is an important part of the investment process, going well beyond the fiduciary duty of exercising voting rights.

For the integration of governance into our investment analysis, we have our dedicated Corporate Governance Centre and several analysts and portfolio managers who are directly involved in the voting process. We analyse the voting items for the AGMs and discuss the content where necessary with the investment professionals. That's how the voting takes place. We also do the other aspect – the governance-related engagements with companies – together with the analysts or portfolio managers for actively covered stocks and within the governance team for all the others. And, I want to underline this, for passive strategies, these activities – in particular the engagements to be able to influence change or improvement in our investees' behaviour – are even more important. For passive investors, as effectively "permanently" invested, the investment decisions cannot be made actively on a single-asset basis and exclusion strategies are fundamentally more difficult.

Q: Dennis: Can I follow up on the data that you have available? DWS we have our ESG engine that combines external signals and gives us information on the ESG position of companies. Could you briefly elaborate on this?

NEZHLA Yes, that's a very important topic in the ESG space and of course to identify the most relevant companies for us we need reliable data and sound analysis. Our own data analysis from the DWS ESG

Engine gives us signals that draw on sources from several data providers, each evaluating different focal points of ESG. From this broad view, we can then identify the so-called ESG leaders and laggards and define starting points for open discussion or engagement with companies. At the CG Centre, we work with a focus list of more than 2,000 companies from a complete universe of more than 7,000 companies, which includes the most relevant portfolio companies selected, based on certain company characteristics, including, for example, ESG ratings.

Q: Dennis: Hendrik, Nezhla has said that there should be open discussions with companies. Can you give us an example or explain how this interaction takes place?

HENDRIK The focus list that Nezhla mentioned is part of our engagement approach. More than 2,000 companies receive a letter from us at the beginning of the year in German or English in which we point out the changes in our Corporate Governance & Proxy Voting Policy and explain the topics that form the engagement focus for us within that year. We combine this with an invitation to a constructive dialogue. Ideally, we will then receive feedback at relatively short notice and find that our suggestions or the invitation to discuss them have been accepted. But of course that doesn't happen for all the suggestions that we provide in our letter.

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From March onwards, the clock starts ticking, because then it's AGM time and the season begins worldwide. It normally lasts until the end of July but in 2020 the last AGMs took place in November. The Covid-19-restrictions were and still are changing the overall AGM landscape, but we have experienced that the AGM-season 2021 has already returned to its usual pace and rhythm. During this time, we are looking more at the votes, at the AGM visits and questions we are filing at the AGMs. Thus, there is no or only very limited scope for dialogue with companies.

Q: Dennis: Can I ask how many times you have been to an AGM in 2020 and 2021?

HENDRIK In January 2020, I went to one of the last that still took place in person – at ThyssenKrupp. However, in March, when the real AGM season normally starts, the law had been changed, the Covid-19 legislation, which allowed companies to hold AGMs then either until the end of the year or as virtual meetings instead. I've sat in on close to a dozen virtual shareholder meetings. In order to ensure that our presence is not lost within the virtual experience, in 2020 we presented 24 companies with questionnaires. In 2021, we have already filed questions at more than 20 AGMs predominantly in Germany and will surpass our 2020 figures by end of May. This includes video-statements, too and to reflect our global ambition, we have also extended our range and submitted questions at international AGMs. We also publish the questions on our website so they are available for our clients and the general public. We have proven that just because we are not able to be present at an annual general meeting, we can still get answers to our questions in this way.

Q: Dennis: You've already said that we can make criticisms in these questionnaires. What happens when the company has learned that you do not agree with parts of their strategy?

HENDRIK In the best case, we receive feedback directly on our voting behaviour and have a conversation. At the end of the voting season, we assess what the critical aspects were and then we write a so-called post-season letter. In these letters, we provide our rationale as to why we voted against and why we did not support certain proposals – once again offering a dialogue in the second half of the year. Our hope is that at this point the management board, supervisory board or a chairperson reacts and that we can then actually get into an effective engagement with these companies and make our point.

Q: Dennis: How can you measure what our engagement on such points has brought?

HENDRIK Let me give you some examples. We can specifically report that there were capital increase proposals from companies that we were not able to support. In an intensive exchange with the legal counsel, the investor relations people, the CFO, the Supervisory Board, we looked at what the company is planning and how it is possible to structure this capital measure so that it meets our requirements. Consequently, the terms were adjusted, the amount of the packages was adjusted, it was explained in more detail what these capital measures are considered to be useful for. Thus, we were then able to approve the proposals. In the area of Executive Board compensation, clawback clauses and extra-financial KPIs were subsequently added, which we advocated because otherwise we could not support these systems. In the case of candidates for the Supervisory Board who, in our opinion, held too many offices at the same time, we were either offered the prospect that these offices would be relinquished in the course of the next 12 months, thereby reaching a level we could accept, or that alternative candidates would actually be proposed.

Q: Dennis: It's good to hear that this dialogue is bringing about results. Nezhla, I learned from you in the preliminary discussion that you are very much responsible for the climate topic. Do you have any examples of what our commitment looks like right now?

NEZHLA Yes. One very interesting example is our participation in the Climate Action 100+ initiative. It's a global initiative we've been supporting for about three years. It's a five-year investor-led initiative to systematically influence major corporate greenhouse gas emitters around the world in order to accelerate the energy transition. We are leading the dialogue with a major European utility company. I can definitely say that this company has worked quite a bit in the last few years to improve. For example, they have set very ambitious GHG reduction targets, which is unfortunately something we don't see that often, not only regarding the so-called Scope 1 and 2 emissions, but also Scope 3.

What are these scopes and why is it so important to publish these emissions?

_ Scope 1 emissions are the most direct as these are the emissions that the company itself emits directly on its own premises in its own production process.
_ Scope 2 emissions include, for example, all emissions associated with purchased energy: the electricity that the company buys from a utility provider, for example, to have light in the office or to operate machines in a factory.
_ And Scope 3 includes indirect CO2 emissions, for example the emissions that have been generated to produce components that are then supplied to the company and further processed in their production process. These are counted as so-called scope 3 upstream emissions. And the products the company manufactures will be used – once sold – and may emit CO2 in their use. These are the so called scope 3 downstream emissions. These Scope 3 emissions are of course the least controllable for the company, that's why it's so important to set targets regarding what the employee, the supplier or the customer emits.

Q: Dennis: Is the information that you generate from these conversations documented and accessible to our customers?

NEZHLA We publish more details about our engagements and voting behaviour in an annual engagement report, and we've been doing that since 2017. With the report, our goal is to make our activities more tangible. The issues are quite complex and, apart from the figures, it is more important for us to demonstrate the quality of our activities. Other asset managers may ask about climate protection in general and whether the company has identified climate risks or opportunities for itself. But we want to go one level deeper and ask specifically about individual measures or oversight within the company that should, in our view, already be addressed by the company.

Q: Dennis: We are one of the bigger Asset Managers in Europe but obviously are not the only one shaping the Corporate Governance debate. Hendrik, are we also working with others to shape the framework?

HENDRIK As we are the largest asset manager in Germany, we have considerable weight – for example in the BVI, our industry association, in which we are involved in various working groups. Since 2021, I am also a member of the Stewardship Committee of the Investment Association in the UK, thus being able to extend our involvement in this area further.

But I would also like to talk about our involvement in the DVFA – the association for investment professionals. On the initiative of DWS, the Commission for Governance and Stewardship was founded within the DVFA. This commission has now been active for five years and has for example developed the DVFA Scorecard for Corporate Governance. For the last five years we have been reviewing the quality of governance not just according to a simple ‚tick box' exercise, but with an actual qualitative evaluation linked to the Dax 30 index. In the last evaluation we also included the MDax in order to get a feeling for the way in which the formal requirements are implemented. Because it is really a question of how independent the supervisory board is, what extra-financial targets are included in the executive board's compensation, etc.

Q: Dennis: A similar question to the one I put to Nezhla – if the DVFA develops a scorecard that gives clear transparency, can clients see it? Is it information that is publicly available?

HENDRIK The results of the evaluations are published annually in our press releases. When it comes to the raw data, this is available to the participating or co-financing investors but can also be purchased for a nominal fee at the DVFA. Of course we can also talk to our clients about the overall results of these evaluations.

Q: Dennis: This dialogue and greater transparency generates information. How is this information taken into account by us when investing, Nezhla?

NEZHLA Firstly, the ESG capabilities at DWS are led by our CIO for Responsible Investments - Petra Pflaum. Petra was also appointed this year to the Sustainable Finance Advisory Board of the German government – a significant development because as an asset manager we play an important role supporting the government, with the goal of strengthening Sustainable Finance in Germany.

Within DWS Petra leads a dedicated ESG team – the Corporate Governance Centre is part of it – and also the ESG Integration Team, which focuses on supporting the integration of ESG into our investment process across active, alternatives and passive. This structure supports a proper integration of our stewardship activities across all of our asset classes.

Q: Dennis: So this ensures that the information you generate is also incorporated in the investment decision. Can you make that a little clearer?

NEZHLA We have an engagement policy and a database, where it's clearly defined when and how an engagement can be initiated and then of course it's documented and communicated with the investment platform. At DWS, we've also been looking at how to do it better and not automatically exclude certain companies or sectors, for example.

In 2020 DWS established a new „Smart Integration" approach. In its first phase, it was implemented for actively managed mutual funds in liquid investment strategies in the EMEA region. But in principle with this approach the individual risks of the companies that represent a potential risk for the portfolios are identified. These are primarily the companies with high climate transition risks and those that violate internationally recognised sustainability standards, for example. And in the relevant instances, the approach will procedurally require a dialogue with the companies to help them step up their ESG practices. So instead of excluding companies across sectors with high risks, our portfolio managers are able to analyse and identify the most material risks and opportunities in a very objective way.

**Q: Dennis: Thank you, Nezhla.
Hendrik, we have now seen the impact on investment decisions and positive risk reduction derived from taking your information into account. Could you perhaps broaden the topic a bit more and show what other impacts your activity has for our clients?**

HENDRIK We also want to expand and raise the overall market standard for governance, and that's why our specifications are stricter than those in the market. We can show that we have been doing this for over 25 years. So there are many factors that give us a certain weight in this discussion and exchange of ideas.

But perhaps we could also take a look back at the demands that have come up again more recently for better prevention of corporate scandals, stronger regulation, and so on and so forth. In my opinion we quickly come back to the first cornerstone of our governance expectations, namely the supervisory board and thus ultimately the people who are to be elected to this board. Even if organisations can be more susceptible or resistant to misconduct, it is the people in the supervisory board who have to question things critically, who really have to follow up on misconduct, and who then have to ultimately object. That's why it's important to bring together candidates with the right character in these boards, to watch over the capital we provide. I think that's a very important development for us, and one in which we are making a very good contribution with our strict requirements, so that this professionalisation of the supervisory boards really moves forward.

**Q: Dennis: Thank you very much for your comments.
Nezhla, I briefly mentioned your Climate Stewardship Paper earlier, and I would like to ask you to provide a closer look at the requirements for companies in relation to their corporate climate policy.**

NEZHLA The awareness of the urgency of climate change has never been so high, especially from the portfolio risk management side.

Many companies around the world have already made important progress, but I think there is still a need for action and unfortunately the approach so far does not go far enough. I believe in particular that Active Ownership activities need to be taken to the next level. And the question is, of course, how can this happen? In our experience, to assess the effectiveness of corporate climate strategies, investors need to focus on five core aspects in particular:

Firstly, companies need to enhance their disclosure of non-financial information and establish clear responsibility and governance for climate-related issues.

Secondly, they also need to set clear climate targets, in line with the Paris Agreement and the UN-supported Sustainable Development Goals.

Next, these targets should be reflected in executive compensation. While some companies have communicated their commitments to reduce CO2 emissions, I would say the changes in terms of compensation plans have unfortunately been rudimentary in recent years.

Additionally, we have the climate-related shareholder proposals. These need to be addressed appropriately by the companies.

Last but not least, I think climate and energy politics fundamentally face major global challenges. Investors and companies need to make sure that there is an alignment between their climate strategies and their corporate lobbying activities, because there are still organisations that are lobbying against climate policies.

Q: Dennis: The issue of climate risks is very present at the moment. For our investors, too. So what could we do to take the issue to the next level and get more traction?

NEZHLA If we want to fundamentally strengthen the global response to climate risks, we as a global economy need to almost halve CO2 emissions in the next 10 years – this is scientifically proven – and so companies, investors as capital providers, and regulators all need to work together towards that goal. And investors should not only encourage companies to improve their disclosure and risk management. They have a more important role to play in pushing companies to shift their strategy and their investment plans to accelerate carbon reduction in a just transition.

Q: Dennis: Hendrik, to sum up, what do you see as the challenge that we face as asset managers, in terms of engagement?

HENDRIK In the last few years, we have seen a clear increase in the need for companies to justify their licence to operate – in other words, what is their actual added value, economically speaking – but also a demand to go beyond that. It is no longer just the traditional industries that are affected, as we perhaps imagined at the beginning: the energy suppliers, automobile manufacturers or utilities. I believe this now affects every company. Let's just take data security, human rights, climate risks, of course, but also acceptance by potential employees, customers, etcetera. These are topics that are coming much more into focus. And anyone who is not prepared to listen, who is not prepared to respond to changing requirements, is of course also a risk from our perspective as asset managers, which we have to identify and take into account. And in this respect, I believe that this approach of continuing to engage in intensive dialogue is absolutely essential.

Dennis: Thank you both for these insights into Corporate Governance and the processes and steps you are undertaking.

In the German ESG Buzz podcast series, experts provide answers on the topic of sustainable investing. The moderator Dennis Haensel is Global Head of the ESG Investment Solutions & ESG Advisory Team.

www.dws.com/de/loesungen/esg/esg-basics/

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