Climate related banking proposals, executive compensation, and incentive programs were among the thorniest issues we dealt with during the 2022 proxy season. We use these examples to illustrate our engagement with managements and boards of directors, and the thought process behind our votes.

Direct engagement and proxy voting are the two primary ways we, as active owners, can seek to influence management teams and steer companies in the direction of long-term shareholder value creation. Stewardship, at Pzena, is led by the members of our research team, as they are the most closely connected to the business issues of our investments.

There are always several particularly complex and inevitably controversial proxy votes that require significant discussion within the research team to arrive at a vote determination. Below, we profile three such votes from the recent 2022 proxy season to illustrate our focus on our fiduciary duties and the long-term sustainability of our investments and how that manifested in our voting and engagement.

EXAMPLE 1: CLIMATE-RELATED BANKING PROPOSALS

This proxy season, banks have come under greater scrutiny as providers of financing to the fossil fuel industry through their loan and capital market activity. Climate-related proxies for financial institutions fell into two categories of proposals: 1) confirming investor satisfaction with banking climate targets; and 2) limiting the types of financing banks provide to the fossil fuel industry.

The first category, "Say-on-Climate" proposals, have become a means for shareholders to express support for, or dissatisfaction with company climate strategy, including stated decarbonization targets. For a bank, this means phasing out direct emissions in their own operations, but more importantly, setting interim targets for decarbonization in high-emitting industries where they provide financing as well as committing to new financing in "greener" or sustainable alternatives. In 2022, several bank management teams requested shareholder input through management proposed "Say-on-Climate" votes. Within our portfolios, these votes came up at UBS, NatWest, and Standard Chartered. In these instances, we thoroughly reviewed the climate plans and spoke directly with the relevant stakeholders. Our votes in favor of the climate plans reflect our view that the management team is approaching decarbonization in a way that is beneficial for the long-term health of the business and its shareholders.

The second category of climate proposals we encountered during this proxy season arose from shareholder activist groups looking to immediately cease all funding of new fossil fuel projects. These proposals, inspired by the IEA Net Zero by 2050 report, which aims to limit global warming to 1.5 degrees Celsius by the end of the century, would require banks to commit (and in some cases amend their Articles of Incorporation) to bar any new financing of oil and gas fields or coal mining developments.

While we recognize the importance of the energy transition, we do not believe that a prescriptive ban on new fossil fuel financing is the best way to achieve global decarbonization goals. These proposals were on the ballot at a number of our financial holdings and we voted against them. Even with extremely aggressive energy transition timelines, oil and gas demand is expected to peak only in the 2030 to 2035 timeline and remain a meaningful part of the global energy mix for an extended period of time. As oil and gas production naturally declines at approximately 8% per annum, constant reinvestment is necessary to ensure supply meets demand. Any overly-hasty withdrawal of capital from the sector is likely to unduly restrict supply, adversely impact the global economy and therefore, potentially reduce the capital available for the energy transition. Additionally, blanket bans on financing certain industries could compromise a bank's ability to serve as partners to their clients in achieving their energy transition goals. We believe that in most cases, management teams at financial institutions are well-positioned to set an appropriate timeline to phase out fossil fuel financing in a way that does not threaten the stability of the global energy supply or the bank's existing relationships.

EXAMPLE 2: SS&C

Executive compensation is a common issue we are faced with during proxy season. Analysts are tasked with judging management pay levels and awards within the scope of company performance, balancing the need to attract and retain key talent without deteriorating shareholder value. Institutional Shareholder Services (ISS), which we use as a third-party resource on proxy voting issues, flagged several components of SS&C's advisory vote on executive compensation as potentially problematic. The matters of concern arose from a severance payout to a departing executive and relatively high compensation awards for both the COO and the Founder/CEO.

Often, we find that the company-specific context is not well-understood by proxy advisors who have limited means of engaging with the companies they cover. This is a critical reason why we believe there is no substitute for the relationships we maintain with management teams. After engaging with SS&C's CEO, General Counsel, and an Independent Director, we learned that the flagged severance payout was a contractual obligation owed to the departing executive and therefore, was improperly handled by ISS. On the issue of COO compensation, the team at SS&C provided us with their rationale for the outsized compensation award, citing his skillset and experience as attractive to many of their competitors who may seek to poach him and thus warranted additional incentives to retain his talents. Our engagements enabled us to feel at ease with the company's decision-making on these components of the advisory vote.

Occasionally, however, the ISS flag may help draw our attention to problematic issues that we are subsequently able to explore in greater depth by engaging with the company. On the issue of CEO compensation, despite an increase in the performance-oriented component of equity, the compensation was excessive and was far outside the range of peers. Even after engagement, we remained convinced that the award was too high to offer our support. Extreme bonus payouts such as this are at the expense of shareholders and led us to vote against the advisory vote on compensation.

EXAMPLE 3: REINSURANCE GROUP OF AMERICA

The macro environment presents challenges for investors assessing the structure of forward-looking incentives. We believe that there is a balance between attracting and retaining key talent and limiting the dilution of shareholder value. Extraordinary equity awards may be permissible on a case-by-case basis, for example, when we feel that management is being unfairly punished for circumstances that are largely beyond their control. We would, however, expect a measure of clarity and appropriateness in the targets and metrics that must be met for a full payout to be earned.

In the case of Reinsurance Group of America — RGA, we found their issuance of a one-time equity award — while well-intentioned, given business disruption from COVID-19 — lacked rigor and failed to protect shareholder value. Notably, the award vested over a short time horizon, shorter, in fact, than the company's regular cycle awards, providing limited long-term incentives to management. Additionally, although the financial metrics selected to evaluate performance were reasonable, the targets for full payout of the award were not disclosed, minimizing the ability to assess performance against company goals. After engaging with the company and learning more about their decision-making process, we were ultimately unable to feel comfortable with these issues. We, therefore, decided to vote against the issuance of this award.

CONCLUSION

These three examples of significant proxy votes from the 2022 season highlight where the nuances of each decision had to be debated extensively, internally, and with company management, to reach a final vote determination. Our focus on long-term shareholder value creation, ESG or otherwise, always guides our decision-making. We believe our focus on bottom-up company-specific research makes us well-placed to evaluate ESG issues in the normal course of investment diligence and to engage with management teams as active owners of the business.

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