ESG Investing: Increasingly a Mainstream Investment Practice

Institutional investors are progressively more aware of the benefits of incorporating the analysis of environmental, social and governance (ESG) factors into their investment decision making. The most recent statistics available showed that more than 38% of the Canadian investment industry, representing $1.5 trillion, had committed to some form of ESG incorporation.[1]

Why Incorporate ESG?

The case for ESG incorporation is rooted in a potential beneficial impact on investment performance and the broader trend towards greater public interest in sustainability. It is supported empirically by a growing body of research that points to a relationship between long term value creation and sustainable business practices.[2] Historically there have been concerns about the alignment of non-financial analysis and fiduciary duty, but that issue is increasingly being laid to rest. In Canada, ESG consideration was given a particularly strong boost by Regulation 909 of the Ontario Pension Benefits Act (PBA), which came into effect on January 1, 2016. Regulation 909 required that all Statements of Investment Policies & Procedures for Ontario registered plans must indicate if, and how, the pension plan's investment policies and procedures incorporate ESG factors. Building on that, the UNEP and PRI published a report in 2016 titled Fiduciary Duty in the 21st Century – Canada Roadmap, which set out recommendations to fully embed the consideration of ESG factors in the fiduciary duties of all institutional investors.

A Brief History and Development Through the Years

Terms like socially responsible investing, or ethical investing, first became popularized in the 1970's with anti-apartheid divestment campaigns and evolved to actively exclude companies involved in specific products such as tobacco, alcohol or controversial weapons. The 80's and 90's brought a sharpened focus on corporate governance and shareholder rights. In Canada, this led to the formation of the Canadian Coalition for Good Governance in 2003. Soon after, in 2006, the United Nations-supported Principles for Responsible Investment were established, galvanizing a global movement toward an integrated and inclusive approach and a more unified ESG nomenclature. There are numerous other organizations that have emerged to support and advance both business and investment practices related to ESG. Among them, the Sustainability Accounting Standards Board was founded in 2011, with the purpose of defining and standardizing corporate reporting on material ESG issues; CDP (formerly Carbon Disclosure Project) was created in 2007, creating a global disclosure system for investors, companies, cities and regions to manage their environmental impacts.

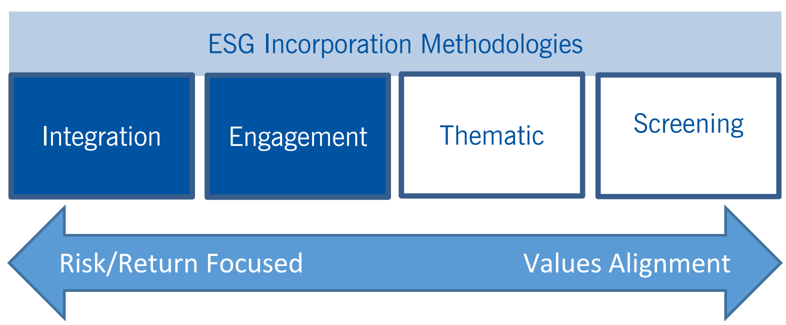
While the ESG framework may be relatively new, there is nothing new in the underlying issues being addressed. On the contrary, ESG is a multi-faceted lens through which to gauge the age-old issue of business quality. Nonetheless, the evolution of the ESG framework has served an important purpose, facilitating broader acceptance and application of sustainable investing by institutional investors.

Multiple Approaches Based On Organizational Objectives

Just as there are many types of institutional investors, there is no one-size-fits-all approach to ESG incorporation. It is important that asset owners understand their rationale for incorporating ESG and carefully consider their options on how to solve for that. A first step would be for Investment Committees to have a discussion about what ESG means to them and why they wish to incorporate it. Understanding the nature and alignment of various practices with their fiduciary duty and investment needs may be very important as well. For example divestment of a particular industry or sector could be perfectly acceptable to an asset owner whose core purpose and mission stand in opposition to a specific industry's products despite the potential impact on future performance. Consultation with stakeholders may be an important part of that process. Ultimately, investors will want to articulate this in a statement of beliefs, or within their investment policy. There are resources available to aid asset owners in this process, such as the Ceres Report: *The 21st Century Investor: Ceres Blueprint for Sustainable Investing.*[3]

Selecting the Right Approach

Broadly, ESG approaches can be categorized into four categories.



Integration – ESG Integration refers to the systematic consideration of material ESG risks and opportunities into an investment decision-making process. The primary focus on integration is to drive better long-term risk-adjusted returns. Combining ESG criteria with fundamental analysis can be very informative to understanding the depth of the company's competitive position and its prospects going forward. To that end, the concept of materiality has recently gained traction. What is material to one business in one sector is not necessarily material to another. For example, metrics for resource intensive businesses like energy or mining might focus on environmental criteria as well as health and safety, whereas those for a human capital intensive business like pharmaceuticals or software development might lean more toward social criteria such as employee attraction and retention rates. When prioritizing integration as an approach, asset owners should look at the extent to which ESG is embedded into a manager's internal research process and capabilities in a robust and consistent manner. In recent years there has been an explosion of ESG ratings, and these can serve as a helpful lens to provoke discussion. However, a lack of standardization and divergence in ratings across providers can be problematic if simply bolted on to an investment process, or used in ways they were not intended.

***Engagement* –** ESG risks are long term in nature. Gaps in corporate governance, or weak environmental practices do not tend to make or break the next quarter. They can, however, have a material impact on long-term shareholder value. By taking an engaged ownership approach, investors have an opportunity to drive accountability and improve corporate stewardship towards increased resilience of the value creation process. If an energy company can be encouraged to do a better job measuring and managing its methane emissions, it may be better positioned to manage changing regulatory risk, while also having a positive effect on long-term climate risk. Many of the world's leading fundamental investors have long taken an engaged approach to governance advocacy, and the degree of activism around E and S issues is evolving along with the availability of the data. In addition, index providers and Universal Owners with very large, broadly diversified portfolios, that reflect the overall global economy may focus primarily on engagement as a means of incorporating ESG.

Engaged ownership can take several forms, from proxy voting, to direct engagement and shareholder proposals, to indirect or collaborative engagements with other investors. Asset owners could choose to take these activities on themselves, outsource to a service provider, or delegate to their investment manager. The size of the organization, resource availability, and key stakeholder concerns are likely to dictate which approach makes the most sense.

Screening – The most common form of screening is negative or exclusionary screening. This approach typically seeks to avoid investing in companies that are inconsistent with an organization's core values. It often involves companies involved in specific product manufacturing such as tobacco or weapons, but also increasingly covers companies involved in significant human rights and business ethics controversies. What is important for investors to understand prior to implementing an exclusionary approach is the degree to which the portfolio diversification and risk are impacted. The process should be well documented and linked to the organization's mission and stakeholder priorities. Other forms of screening involve best-in-class quantitative approaches and norms-based screening that seeks company alignment with specific international norms and standards.

Screening can be thought of as a means to deepen the alignment of an organization's capital with its mission and values. There are many off-the-shelf products available that incorporate a range of standard screens. However, asset owners may wish to take a more customized approach, to better understand how various screening choices impact their portfolio risk characteristics. Which approach makes the most sense may be determined by the size of the organization, the capabilities of their existing managers and the degree to which their key stakeholder concerns are unique.

Thematic – Thematic investing is a smaller but growing approach to ESG incorporation, with some asset owners electing to allocate a portion of their assets to certain sustainability themes. Examples include low carbon investments, fossil fuel free portfolios, and even strategies based on gender diversity. The reasons for these allocations are varied and may include increased values-alignment, a desire for positive impact, or perhaps investment performance optionality based on a particular macro thesis or world view.

Selecting An Investment Manager

An organization should take the time to understand its needs, outline its beliefs, and prioritize which approaches make the most sense for them. Many investment managers employ a combination of approaches. When considering manager fit, some important considerations include:

- *How is ESG governed with the Manager? Do they have an ESG Policy?*
- *What is their approach to incorporation? Is it outsourced or embedded?*
- *How long has the Manager been incorporating ESG?*
- *What is their service delivery model? Product centric vs. consultative?*

Reviewing an investment manager's PRI Transparency & Assessment Reports can be a helpful starting point to understand their approach and spark discussion.

Building A Successful Relationship

Unlike other forms of financial innovation, the evolution of ESG is less about product, and more about process. As such, there is no one-size-fits all solution. Asset owners should engage their managers in a discussion about their unique ESG beliefs and objectives, and seek to understand their manager's core approach and capabilities. Communication should be a two-way street, and asset owners should work with managers to develop a reporting framework that meets their needs. Reporting may include updates on ESG tools and processes, ESG KPI's, case studies, proxy voting activity, engagement activity, and industry collaborations. Ultimately, the most successful relationships will be built on collaboration, candor and commitment.

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[1] http://www.riacanada.ca/trendsreport/

[2] For example, see 22 Research Studies Proving The ROI of Sustainability, Sustainable Brands, 2016 http://e.sustainablebrands.com/resources-report-22-research-studies-proving-the-roi-of-sustainability.html

[3] The report can be accessed at http://www.jflglobal.com/en/articles/ceres-blueprint-sustainable-investing/