ESG EXPLAINED

RESPONSIBLE INVESTING: A CORNERSTONE IN MODERN PORTFOLIO MANAGEMENT

A SUMMARY OF RESPONSIBLE INVESTING, ITS UNDERLYING PRINCIPLES AND GROWTH POTENTIAL

Responsible investing has evolved significantly over the years; however, its growth and adoption has never been greater. Environmental, social and governance (ESG) factors can be integrated at the beginning of the portfolio management process or incrementally over time. Either way, Responsible investing helps manage risk, bolsters returns and elevates a manager’s decision-making capabilities.

What are ESG factors?

ESG factors help portfolio managers categorize investment risks, those within and external to a business. By categorizing the risks a business faces based on ESG factors, it’s possible to:

• Assess a company’s risk exposure
• Measure the capital investments required to mitigate these risks
• Continually assess a company’s future performance based on financial and ESG factors

Examples of ESG factors

<table>
<thead>
<tr>
<th>Environmental</th>
<th>Social</th>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Climate change</td>
<td>• Health and safety</td>
<td>• Board of directors</td>
</tr>
<tr>
<td>• Environmental protection</td>
<td>• Privacy and data</td>
<td>• Business ethics</td>
</tr>
<tr>
<td>• Water and energy use</td>
<td>• Labour relations and employment quality</td>
<td>• Legal and regulatory compliance</td>
</tr>
<tr>
<td>• Resource efficiency</td>
<td>• Human rights</td>
<td>• Executive compensation</td>
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<tr>
<td>• Waste management</td>
<td>• Respect for civil liberties</td>
<td>• Disclosure</td>
</tr>
<tr>
<td>• Regulatory threshold and compliance</td>
<td>• Community relations and social media</td>
<td>• Inclusion and diversity</td>
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<tr>
<td>• Assessment and disclosure</td>
<td>• Product responsibility</td>
<td>• Monetary transparency</td>
</tr>
<tr>
<td></td>
<td>• Respect for cultural and ethnic identities</td>
<td>• Fiscal transparency</td>
</tr>
<tr>
<td></td>
<td>• Human health</td>
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1. How are ESG factors used in the investment process?

The way ESG factors are used in the investment process is dependent on the responsible investment approach an asset manager adopts. As per the chart below, responsible investing is a spectrum, allowing asset managers to choose where, and in what combination, to implement ESG factors within their investment process.

<table>
<thead>
<tr>
<th>Process</th>
<th>Traditional investments</th>
<th>Responsible and ethical investment</th>
<th>Philanthropy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approach</td>
<td>ESG integrations</td>
<td>Exclusively/ negative screening</td>
<td></td>
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<td></td>
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<td>Norms-based screening</td>
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<td></td>
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<td>Corporate engagement and shareholder action</td>
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<td></td>
<td></td>
<td>Positive/best-in-class screening</td>
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<td>Sustainability-themed investing</td>
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<td></td>
<td></td>
<td>Impact investing</td>
<td></td>
</tr>
</tbody>
</table>

**Method**

- Providing limited or no regard for environmental, social, governance and ethical factors in investment decision making.
- Excluding certain sectors, companies, countries, or issuers based on activities considered not investable due principally to unacceptable downside risk or values misalignment.
- Screening of companies and issuers that do not meet minimum standards of business practice based on international norms and conventions; can include screening for involvement in controversies.
- Executing shareholder rights and fulfilling fiduciary duties to signal desired corporate behaviours - includes corporate engagement and filing or co-filing shareholder proposals, and proxy voting guided by comprehensive ESG guideline.
- Intentionally tilting a proportion of a portfolio towards solutions; or targeting companies or industries assessed to have better ESG performance relative to benchmarks or peers.
- Specifically targeting investment themes e.g. sustainable agriculture, green property, ‘low carbon’, Paris or SDG-aligned.
- Investing to achieve positive social and environmental impacts – requires measuring and reporting against these, demonstrating the intentionality of investors and underlying asset/investee and (ideally) the investor contribution.
- Using grants to target positive social and environmental outcomes with no direct financial return.

**Intention**

- Avoids Harm
- Benefits stakeholders
- Contributes to solutions

**Features and outcomes**

- Delivers competitive financial returns
- Manages ESG risks
- Delivers competitive financial returns
- Pursues opportunities and creates real outcomes

The intention and outcome of all responsible investment approaches are to:

- Avoid harmful behavior
- Mitigate investment risk
- Deliver competitive financial returns

However, specific responsible investment approaches are tailored to fulfill specific socioeconomic objectives and better the lives of stakeholders.
2. Why is responsible investing important now?

The growing importance of ESG factors and responsible investment can be attributed to (I) increasing investor value alignment and (II) the strong, demonstrable performance benefits of responsible investing. Read on for more details.

I. Investor value alignment

As the investment landscape grows, Canadians are increasingly looking for companies that invest thoughtfully and deliver sustainable growth, while aligning with their personal beliefs. For advocates of responsible investing, the United Nations Principles of Responsible Investment (UNPRI) is often a starting point. The UNPRI helps evaluate an asset manager’s responsible investment philosophy and may be a proxy for responsible investment’s global growth.

Many asset managers recognize the importance personal values play in the investor decision-making process and the increased number of signatories to the UNPRI indicates this. Including ESG factors in the investment process is now an expectation, not a preference. This indicates a stakeholder – not just a shareholder – view of evaluating a business provides a much deeper understanding of the firm’s operations and whether its activities are truly sustainable over the long term.

II. Strong, demonstrable performance

There’s growing evidence that incorporating ESG factors into the investment process doesn’t lead to lower rates of return—the primary objection to responsible investing in the past. Research shows that investors who pursue investment products that incorporate ESG factors don’t suffer a performance penalty. Market index data verifies this, shown below in the performance comparison between the MSCI World and MSCI World SRI indices.

MSCI World SRI vs. MSCI World

Chart illustrating a 1-Year, 2-Month rolling returns and return differentials between indices, from March 2016 to February 2021

Source: Morningstar, March 2021
Conclusion

While the way ESG factors are implemented during the investment management process may vary, there’s a clear benefit for investors who choose responsible investing. ESG factors and responsible investing are becoming a foundation of the portfolio management process and provide asset managers and investors material benefits.