Segal Rogerscasey Canada

INVESTMENT BRIEF

HOT TOPIC March 2016

Responsible Investing: A Reintroduction

Since the Global Financial Crisis, Environmental, Social and Governance (ESG) investing and related topics have experienced a surge in interest now that investors are able to focus on more than just navigating their portfolios through the ailing markets.

Segal Rogerscasey (the U.S. investment solutions member of The Segal Group) was an early adopter of the United Nations Principles of Responsible Investing,[1] a program launched in April 2006 that centres on the global support of ESG investment doctrines. This *Investment Brief* reintroduces the topic of ESG and unravels confusion surrounding the terminology applied to this and related areas of Responsible Investing.

Background

The first large-scale implementation of investing with a conscience in the U.S. came with the advent of Socially Responsible Investing (SRI) mandates in the 1980s. Investors would determine that there was a social issue, such as tobacco, apartheid or weapons, that they preferred not to support with their investment dollars, and securities whose sponsors had exposure to such issues were screened out of the investable universe for that entity. Although some products were developed with standardized social screens, oftentimes SRI was an individually-tailored decision, so plan sponsors had to identify managers willing to narrow their investment universe, possibly sacrificing returns as a consequence.

Investment managers that were not charged by their clients with avoiding certain kinds of stocks paid little attention to the SRI movement, convinced that the broader area of Responsible Investing was not for them. Many stopped paying attention to the subject altogether.

What Is ESG?

Like SRI, ESG is another way to invest with a conscience, but the approach is vastly different from that of SRI investing. Instead of compiling a personalized list of companies providing products that are anathema to a particular investor, ESG seeks to invest with companies that are acting in a positive fashion, either through their business practices or their goods or services.

The topic of ESG gained significant traction in Europe earlier in the millennium, partly because the effects of environmental misbehaviour were more noticeable and more keenly felt in that more densely populated region. On the western side of the Atlantic, many U.S. investors may have been under the impression that ESG was just a rebranding of SRI, which they had already decided was not their mandate, and so largely avoided considering ESG for their investment program.

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The components of ESG are defined below:

- ***Environmental*** Definitions vary, but generally there are two types of stocks sought for their environmental qualifications. The first are companies with good absolute or better-than-peers practices when it comes to environmental stewardship, such as paper companies that reinvest significantly in reforestation. The second type are companies whose products or services solve environmental problems, such as companies that clean coal plants or provide affordable solar-power equipment.
- ***Social*** The social aspect of ESG is concerned with how the company treats its various stakeholders, including employees, customers and the communities in which they operate. Companies that ensure high standards for workers' health and safety are generally viewed as more sustainable, as they should face less litigation or bad press. In addition, companies that treat employees well are more likely to have a stable and loyal workforce, which lowers turnover costs and helps in times of economic stress when more may be asked of the staff.
- ***Governance*** This component of ESG has to do with how the company is run. It includes board structure, executive compensation and treatment of outside shareholders. Companies with outside board members are seen as more likely to avoid "groupthink" and to operate in the interest of shareholders and not only that of management. Compensation should align the interests of management with those of shareholders, ensuring that any actions made to enrich management should also accrue wealth to those who hold the stock.

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[1] For more information about the U.N. Principles of Responsible Investing, visit http://www.unpri.org.

"As long as a fiduciary is not explicitly accepting a lower return in order to further ESG goals, it is now more acceptable to seek out such investments."

Approaches under the Responsible Investing Umbrella

As with most investment concepts, products offered with the ESG label are not at all homogenous. When money management firms indicate in databases that they can offer an ESG version of a strategy, they are often only expressing a willingness to exclude stocks that clients find objectionable. These are really SRI offerings. Other asset managers consider factors like governance and environmental record in the normal course of their assessment of a company's quality, but less for altruistic reasons and more for wanting to avoid companies whose misbehaviour might cause stock prices to fall. A third type of offering comes from firms that actively seek companies conducting business in a responsible way, believing that such companies are more likely to survive bad times and be well-positioned to succeed in good times. Finally, there are investors who take more of an activist approach, engaging management and boards in an attempt to improve a company's environmental, social or governance behaviour.

Another Responsible Investing topic is captured by the term Sustainable Investing, which can mean different things to different people. In some cases, it is an investment practice that seeks to promote energy sufficiency by avoiding fossil fuels and investing in alternative energy sources. For others, Sustainable Investing involves looking for companies that operate in a sustainable way such that they have a high likelihood of being in business many years into the future. This may simply mean that businesses are cash-flow positive to a sufficient degree that they should not need to access the financial markets to implement plans for growth. Thus, in some instances, Sustainable Investing may have nothing to do with environmental or social responsibility.

Taking the ESG concept further, Impact Investing is a more active approach to Responsible Investing, in which practitioners use their assets to effect positive change by starting or investing alongside businesses with products or services that allow customers to improve the world. One example would be a private equity program investing directly in timber companies with a strong record of reforesting in order to help lower global carbon-dioxide levels.

Legal and Fiduciary Concerns

Another reason Canadian investors may have been slow to support ESG is that it was not entirely clear whether a fiduciary could be considered to be acting prudently in seeking out what have been described as collateral benefits to an investment program. The problem seemed to be that, in seeking to have investment dollars provide positive societal effects, fiduciaries might be giving up investment returns in favour of those benefits, a stance that could be seen as not fulfilling their fiduciary responsibility. In 2005, one of the world's largest law firms, Freshfields Bruckhaus Deringer, provided a legal review[2] stating that the law permits the integration of ESG issues into an investment program and that doing so is not against fiduciary trustee duties. In 2016, Ontario became the first province to mandate the decision of ESG factors into plans' investment guidelines and procedures.

Doing Well by Doing Good

Many who manage ESG strategies have concluded that companies that operate responsibly have a strong likelihood of surviving and prospering over the long term, which makes them attractive investment opportunities. The thinking is that by avoiding lawsuits, unsafe products and workplaces, and other events likely to generate negative publicity, financial penalties and disruption, companies can focus on operating and growing their businesses.

In summary, beyond the feel-good aspects of investing in companies that are having a positive impact on the planet and those living on it, there is no reason to believe that the investment returns from such companies will be substandard. In fact, they may even be better over the long term. ■

[2] See the paper, "A legal framework for the integration of environmental, social and governance issues into institutional investment"

Questions? Contact Us.

For more information on ESG and considerations for your investment program, contact your Segal Rogerscasey Canada consultant or one of the following investment professionals:

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