Trends & Ideas

PRIVATE CLIENT SOLUTIONS

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A Changing Investment Climate

ESG (environmental, social, governance) is a newer, but increasingly growing topic in the world of investments. Both institutional and retail investors are paying closer attention to ESG for various reasons whether they believe this will improve long term returns, align more with their values or want to have a positive impact on the world. Institutional investors, however, have utilized ESG principles more compared to retail investors. According to Bloomberg, ESG funds from DWS and Blackrock received $800 mln in seed capital from pensions, making them the two largest US ETFs launched this year. To understand just how important ESG is becoming to institutional investors, one can see signatories of the United Nations Principles for Responsible Investment (UN PRI), which had reached over 2,232 in 2018, or a 21% increase over 2017. As shown on their website, the UN PRI, created in 2006,

> *"works to understand the investment implications of environmental, social and governance (ESG) factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions."*

Being a signatory means investors voluntarily commit to six principles, one of which is to incorporate ESG issues into their investment decision making process. Millennials and women have been pointed to as the leading proponents of ESG and demand is expected to continue to grow. Global companies are also facing many sustainability challenges related to data protection and privacy, climate change and carbon emissions and board composition among others. Such challenges mean investors will have to look at investments differently than they currently are and may need to revaluate their traditional way of analyzing securities.

Intro to ESG

The term ESG refers to a set of criteria related to environmental, social and governance factors that are being applied as part of the investment decision making process. While the traditional way of investing focuses on company financials, ESG officially overlays the security analysis process with non-financial attributes for the purpose of identifying risks and opportunities, helping lead to a more complete company view and better-informed decisions.

- The "E" part of ESG assesses a company's impact on the environment, focusing on issues such as energy efficiency, waste management or biodiversity. This allows investors to determine the type of impact a company has on nature along with the risks a company may be facing, such as toxic emissions management or ownership of contaminated land, and how the company is mitigating or managing those risks. Think no further than the BP oil spill of 2010, which was the largest marine oil spill in history. This event slashed BP's stock by almost a quarter that year (compared to the S&P 500 Energy Sector Index that was up 17.8%). The spill was so bad Hollywood created a movie in 2016 titled *Deepwater Horizon* with Mark Wahlberg. ESG investors at the time noticed BP lacked safety standards and management oversight, so they knew to avoid the name. Investors may want to look into whether a company has environmental goals, and especially if they track progress in achieving those goals.

Examples of ESG Considerations

Environmental	Social	Governance
Air and water pollution	Community relations	Audit committee structure
Biodiversity	Customer satisfaction	Board composition
Climate change and carbon emissions	Data protection and privacy	Bribery and corruption
Deforestation	Employee engagement	Executive compensation
Energy efficiency	Gender and diversity	Lobbying
Waste management	Human rights	Political contributions
Water scarcity	Labor standards	Whistleblower schemes

Source: Raymond James Ltd.

- The social aspect of ESG has to do with the impact a company has on the people that it deals with, including its employees, customers, neighbours and suppliers. Issues range from customer satisfaction and employee engagement to community relations. An example of a recent incident is the General Motors (GM) and United Automobile Workers (UAW) strike that began September 15 and resulted in a 40-day halt to GM production, causing an estimated $3 – 4 bln loss in 2019 profits for the company. Investors looking for more information on a company's social impact can look at third-party platforms (on top of what companies disclose), including media coverage on how certain companies treat their employees, lobbying efforts, along with lists highlighting the work environment such as Fortune's Best Companies to Work For. Glassdoor.com can also help gauge a

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company's management by sifting through employee reviews.

- Governance issues help determine whether management is shareholder friendly, assess company oversight and avoid conflicts of interest. Think about Enron's accounting scandal, which stemmed from management's increased obsession with short-term earnings for higher bonuses and eventually led to the demise of the energy company. Annual proxy statements filed by companies cover a variety of corporate governance topics such as executive compensation, which helps determine whether management incentives align them with shareholders. Management with "skin in the game" shows they have a personal incentive to steer the company in the right direction.

When it comes to incorporating ESG into their investment process, investors may look at an array of considerations. While the table above highlights some of the key issues under each umbrella, the Ethical Investment Research Services has assessed that there may be as many as 250. A few institutions are working on standardizing and defining some of the key factors and how to incorporate these in the investment process such as the Sustainable Accounting Standards Board (SASB), the Global Reporting Initiative (GRI) and Carbon Disclosure Project (CDP). Investors looking to find out more about a specific company's ESG impact can look over sustainability reports that employ the above mentioned sustainability standards as well as data providers such as Sustainalytics, Refinitiv, MSCI and S&P Global.

Some History

In 1970, Milton Friedman popularized the shareholder value theory, or Friedman Doctrine, that states a company's main social responsibility is to its shareholders, maximizing shareholder value and, above all, increasing company profits. While Friedman did not bring about ESG (a term coined in 2005), his theory gave momentum to the idea of responsible investing (RI). The idea that pursuing profit at the expense of other stakeholders (employees, customers, suppliers, communities, and the environment) may eventually negatively impact financial results one way or another in the long term. Over time, RI came to include socially responsible investing (SRI), impact investing and ESG. In fact, SRI is deeply rooted in human history, dating back to religious texts that advised on, and defined, ethical investments. In the 1960's, amid the Vietnam War, protesters in the US demanded the removal of defense contractors from university endowment funds. The idea gained momentum in the 70's with the 80's also seeing increased divestment from companies operating in South Africa, during the time of apartheid. Investors that adhere to SRI do not want to be involved in certain companies for moral reasons, allowing those that held dearly to certain beliefs to exclude companies that operated in specific sectors. Compared to ESG, SRI is more of a thematic investment approach while ESG applies to many situations. Over the years, responsible investing brought about impact investing; using investment capital in pursuit of companies that specifically bring change for social and environmental problems while also returning a profit. While such styles used negative screening (excluding companies that to not comply with a social or environmental criteria) to some degree, contrary to popular belief, ESG mandates do not always exclude specific sectors, such as energy, from their framework, but help find value in all companies with the intent to find the best-in-class within every sector. Further research in the ESG realm identified sector-specific material issues that mattered for an industry's long term success, helping draw a clear link between ESG impact and economic performance. SASB created the SASB Materiality Map (table on page 4), a tool that helps identify disclosure topics across sectors and industries and can help investors determine exposure to risks and opportunities. According to SASB, material issues are those that are "reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors." Research has shown that companies that focus their sustainability efforts on material factors tend to outperform peers that focus on non-material social and environmental efforts. It's worth noting that a material factor for one industry may not be for another.

Limitations to the Framework

While ESG is a useful framework to incorporate in the investment decision making process, we note that some limitations exist at the moment.

- **Rating inconsistency.** Studies have shown a low correlation of ESG rankings among the top ESG rating agencies, indicating differences in rating scales and objectives. Particularly, data on social factors is not as standardized given differing methods of assessing social impact. Additionally, given a lack of standardized disclosures, rating agencies need to make some assumptions, which only adds to the subjectivity of ESG ratings.
- **Small/mid caps.** Larger companies may have the capability to allocate resources for improved ESG disclosure, something small-to-medium cap companies may not be able to do. As such, smaller companies may be awarded lower ratings despite better true ESG profiles.

- **Not company-specific.** The previously mentioned SASB framework falls short in terms of assessing company-specific competitive positioning, rather focusing on generic industry issues. While this may help identify lagging industries and help increase best practices, it does not identify truly innovative companies. For instance, logistics companies aim to reduce fuel consumption to reduce carbon emissions, but such a move will not result in one particular company developing a competitive advantage. As such, company-specific risks and opportunities may not be well represented in ratings.

ESG Ideas

Investors looking for Canadian ESG-related ideas could start with members of the Jantzi Social Index from Sustainalytics. According to their website, "It is a socially screened, market capitalization-weighted common stock index modeled on the S&P/TSX 60 consisting of 50 Canadian companies that pass broad set of ESG criteria." Other broad-based ESG indices are also provided by MSCI and S&P. Blackrock offers the **iShares Jantzi Social Index ETF (XEN)**, which seeks to replicate the performance of the Jantzi Social Index. Other ETFs to consider for idea generation are **Xtrackers MSCI USA ESG Leaders Equity ETF (USSG US)** and **iShares MSCI USA ESG Enhanced ETF (EEDS listed in London)**. Below we highlight the top 10 equity holdings from XEN, USSG and EEDS.

Top Ten XEN Holdings

Ticker	Name	Sector	Weight
RY	Royal Bank Of Canada	Financials	10.5%
TD	Toronto Dominion	Financials	10.3%
CNR	Canadian National Railway	Industrials	9.8%
BMO	Bank Of Montreal	Financials	7.4%
SU	Suncor Energy Inc	Energy	7.3%
BCE	Bce Inc	Communication	6.5%
SLF	Sun Life Financial Inc	Financials	4.1%
T	Telus Corp	Communication	3.3%
QSR	Restaurants Brands Int'l	Consumer Discretionary	3.0%
GIB.A	CGI Inc	Information Technology	2.9%

Source: Blackrock Website, Raymond James Ltd.

Top Ten EEDS Holdings

Ticker	Name	Sector	Weight
MSFT	Microsoft Corp	Information Technology	4.5%
AAPL	Apple Inc	Information Technology	4.3%
AMZN	Amazon Com Inc	Consumer Discretionary	2.6%
GOOG	Alphabet Inc Class C	Communication	1.9%
FB	Facebook Class A Inc	Communication	1.6%
HD	Home Depot Inc	Consumer Discretionary	1.4%
PG	Procter & Gamble	Consumer Staples	1.4%
NEE	Nextera Energy Inc	Utilities	1.3%
JPM	Jpmorgan Chase & Co	Financials	1.3%
GOOGL	Alphabet Inc Class A	Communication	1.2%

Source: iShares Website, Raymond James Ltd.

Top Ten USSG Holdings

Ticker	Name	Sector	Weight
MSFT	Microsoft Corp	Information Technology	7.8%
GOOG UW	Alphabet Class C	Information Technology	3.0%
GOOGL	Alphabet Class A	Information Technology	2.9%
JNJ	Johnson & Johnson	Health Care	2.5%
V	Visa Inc-Class A Shares	Information Technology	2.3%
PG	Procter & Gamble Co	Consumer Staples	2.3%
HD	Home Depot Inc	Consumer Discretionary	1.9%
INTC	Intel Corp	Information Technology	1.9%
MA	Mastercard Inc-Class A	Information Technology	1.9%
VZ	Verizon Communications Inc	Communication Services	1.8%

Source: DWS Website, Raymond James Ltd.

SASB Materiality Map

		Consumer Goods	Extractives & Minerals Processing	Financials	Food & Beverage	Health Care	Infrastructure	Renewable Resources & Alternative Energy	Resource Transformation	Services	Technology & Communications	Transportation
Dimension	General Issue Category	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand
Environment	GHG Emissions											
	Air Quality											
	Energy Management											
	Water & Wastewater Management											
	Waste & Hazardous Materials Management											
	Ecological Impacts											
Social Capital	Human Rights & Community Relations											
	Customer Privacy											
	Data Security											
	Access & Affordability											
	Product Quality & Safety											
	Customer Welfare											
	Selling Practices & Product Labeling											
Human Capital	Labor Practices											
	Employee Health & Safety											
	Employee Engagement, Diversity & Inclusion											
Business Model & Innovation	Product Design & Lifecycle Management											
	Business Model Resilience											
	Supply Chain Management											
	Materials Sourcing & Efficiency											
	Physical Impacts of Climate Change											
Leadership & Governance	Business Ethics											
	Competitive Behavior											
	Management of the Legal & Regulatory Environment											
	Critical Incident Risk Management											
	Systemic Risk Management											

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