Market Perspectives

PRIVATE CLIENT SOLUTIONS

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ESG During Pandemic Times

Environment, Social, and Governance (ESG) investing has been a headline subject over the past couple years in the Canadian retail landscape. Many investment firms are considering, or are already in the process of, integrating an ESG framework into their practices as availability of data sets and sharing of best practices expands. The trend has been driven by a variety reasons. We are not looking to delve into the ABC's of ESG per se; rather we highlight how the ESG landscape has progressed through a thus-far tumultuous 2020. In particular, we'll look to see whether one of the biggest market meltdowns in modern history has caused investors to move away from ESG funds and how ESG funds performed so far this year.

- There now exists a swath of products that offer broad-based index exposure to Canadian and global equity markets with an ESG tilt in addition to thematic opportunities, such as low carbon funds. Looking to our peers in the US, according to Bloomberg Intelligence there were 40 ESG ETFs launched in Q1 in the US, compared to 84 for all of 2019.
- According to Morningstar there were 86 Canadian-domiciled funds available as of March 31st that go beyond just considering ESG as a part their process and instead fully incorporate ESG as a core analytical tool. At roughly $7.5 billion, sustainable investment assets in Canada consist of a paltry <1% of total fund assets. However, the tide is turning with over $1 billion in net inflows into ESG funds in Q1 of this year, which eclipses the entirety of net inflows into ESG funds in all of 2019.
- Of the 86 funds analyzed 35% of ESG funds ranked in the top quartile while 73% ranked in the top two quartiles. This trend is not exclusive to Canada - research from Bloomberg on US ETFs showed that 59% outperformed the S&P 500 index in Q1 with similar trends in Europe, with 60% of European ESG ETFs outpacing the MSCI Europe Index.
- According to research by global investment management firm Loomis, Sayles & Co. the global green bond market has grown from issuance of less than US$20 billion in 2013 to more than US$200 billion last year. We expect issuance of green bonds, and related products such as social bonds, to continue increasing as investors look to align their portfolios with environmental and social goals.

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ESG During Pandemic Times

Environment, **S**ocial, and **G**overnance (ESG) investing has been a headline subject over the past couple years in the Canadian retail landscape. Many investment firms are considering, or are already in the process of, integrating an ESG framework into their practices as availability of data sets and sharing of best practices expands. The trend has been driven by a variety reasons. Demand for investment solutions that align with more environmentally conscious client values is typically cited as a popular reason for adopting ESG. However, as more academics and industry resources generate in-depth research, we see investors adopting ESG analysis to meet many other objectives. A survey of institutional investors by RBC Global Asset Management last year found that increasing risk-adjusted returns and meeting fiduciary duty to clients were prime reasons for incorporating ESG in the investment process. We are not looking to delve into the ABC's of ESG per se; rather we highlight how the ESG landscape has progressed through a thus-far tumultuous 2020. In particular, we'll look to see whether one of the biggest market meltdowns in modern history has caused investors to move away from ESG funds and how ESG funds performed so far this year. For the purposes of this report we define ESG investing as the process of incorporating the analysis of environment, social and governance issues within the portfolio management process. This may or may not align with an investor's values whereas socially responsible investing (SRI) typically describes investing in alignment with one's values.

Availability of ESG Products Growing

ESG analysis is widely utilized by institutional investors, including pension funds and endowments, and its interest among retail investors has been steadily growing, particularly among millennials. To wit, mutual fund and ETF providers in Canada have been increasingly launching new products to cater to these investors. There now exists a swath of products that offer broad-based index exposure to Canadian and global equity markets with an ESG tilt in addition to thematic opportunities, such as low carbon funds. Looking to our peers in the US, according to Bloomberg Intelligence there were 40 ESG ETFs launched in Q1 in the US, compared to 84 for all of 2019. Interestingly, the cost of products has been declining as more fund manufacturers begin offering variations of broad-based, passively managed mandates with an ESG overlay. In Canada we also saw this trend with both BMO Global Asset Management and RBC Global Asset Management launching a suite of passive ESG ETFs this year.

U.S. ETF Fund Launches

Period	Funds Created	Median Expense Ratio
Q1/2020	40	0.23%
2019	84	0.30%
2018	98	0.25%
2017	45	0.30%
2016	46	0.34%

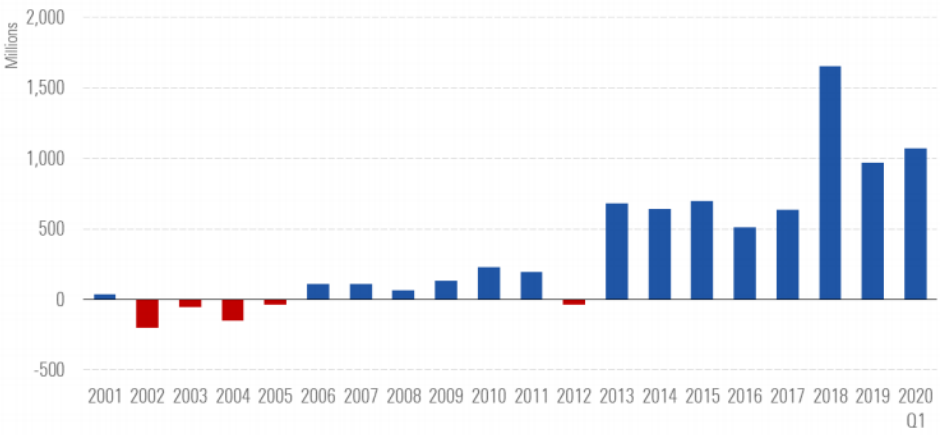
Source: Bloomberg Intelligence

Follow the Money

According to Morningstar there were 86 Canadian-domiciled funds available as of March 31st that go beyond just considering ESG as a part their process and instead

fully incorporate ESG as a core analytical tool. At roughly $7.5 billion, sustainable investment assets in Canada consist of a paltry <1% of total fund assets. However, the tide is turning with over $1 billion in net inflows into ESG funds in Q1 of this year, which eclipses the entirety of net inflows into ESG funds in all of 2019. The trends are similar south of the border, with Bloomberg research noting that ESG ETFs in the US claimed nearly US$7 billion in net inflows in Q1 alone. It is important to note that the vast majority of funds in Canada with an ESG focus, as defined by Morningstar, are equity mandates, with only 19 balanced mandates and 8 fixed income. As we discussed in our Q1/2020 Managed Money report the overall Canadian ETF and Mutual Fund universe saw significant net inflows into equity mandates with considerably higher net outflows from fixed income mandates. Therefore, this skewness to equity mandates is something to keep mind when considering statistics on the aggregate performance of all ESG funds.

Estimated Net Flows to Canadian Sustainable Investments (CAD, Millions)



Source: Morningstar Direct

Do Flows = Performance?

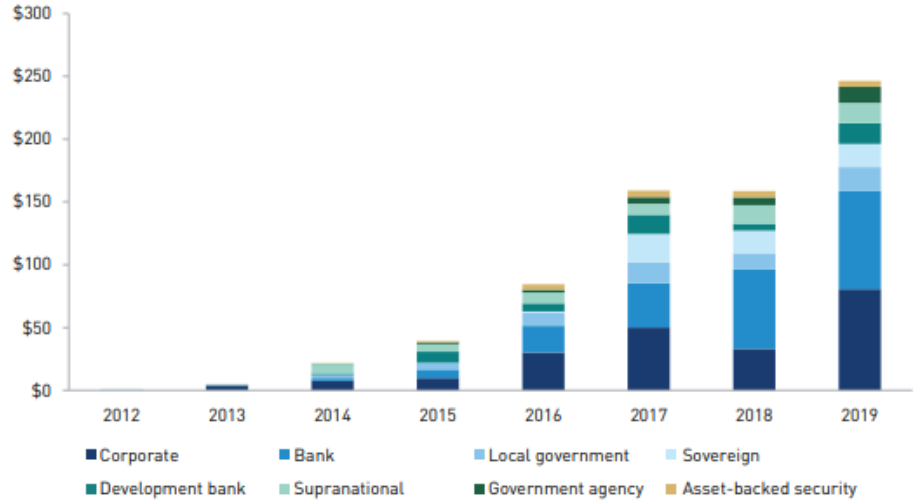
As discussed above, there is no denying investors' interests into ESG funds over the past several months. However, in evaluating the efficacy of ESG investing in being a value add to the investment process, we must look beyond to see how performance has held up versus less-restricted peers. Looking at evidence from Morningstar and Bloomberg the data sheds a positive light on ESG. Morningstar looked at the performance of all 86 ESG focused funds in Canada and compared their Q1/2020 performance relative to each fund's Morningstar category. For example, a Canadian equity ESG fund would be ranked against all Canadian equity funds. Of the 86 funds analyzed 35% of ESG funds ranked in the top quartile while 73% ranked in the top two quartiles. This trend is not exclusive to Canada – research from Bloomberg on US ETFs showed that 59% outperformed the S&P 500 index in Q1 with similar trends in Europe, with 60% of European ESG ETFs outpacing the MSCI Europe Index.

Trends in Fixed Income

Taking a closer look we see that the performance of Canadian-domiciled fixed Income mandates focused on ESG were split, with only 5 of the 8 fixed income ESG mandates placing in the top two quartiles versus peers. That the performance was more varied in this asset class is likely due to the fact that incorporating ESG analysis into credit investing is fairly nuanced and can often look different across fixed income portfolio managers when put into practice. According to RBC Global Asset Management

approximately 87% of surveyed institutional investors incorporate ESG analysis into their investment processes when managing equities while the figure stands at only 62% for fixed income. One aspect that may drive the push into ESG investing in fixed income is the continued growth in global green bond issuance. According to research by global investment management firm Loomis, Sayles & Co. the global green bond market has grown from issuance of less than US$20 billion in 2013 to more than US$200 billion last year. We expect issuance of green bonds, and related products such as social bonds, to continue increasing as investors look to align their portfolios with environmental and social goals. Despite not being through the crisis from an economic perspective many investors are beginning to focus on some of the long-term investment themes that these bonds aim to address. For example, green bond and social bond proceeds often focus on issues such as alternative energy, sustainable water, climate adaptation, affordable housing, and access to healthcare and education.

Global Green Bond Issuance by Issuer Type



Source: Loomis, Sayles & Company, L.P

Contributors to ESG Performance

Given the collapse in oil prices and securities in the energy sector, we examined the strength of the link between them and ESG funds, which often have a low carbon intensity focus. As we expected these funds outperformed. The natural underweight to energy-intensive companies typically corresponds with ESG funds having an overweight to technology stocks. Considering that parts of the technology sector have been one of the few pillars of the market this year it is no wonder that many ESG funds have outperformed their peers. However, not all ESG funds are simply environmentally friendly, therefore given the diversity in ESG mandates available this alone can't explain how ESG funds have broadly outperformed. Have the S and G components of ESG played a big role of performance during the pandemic?

Researchers at Harvard Business School collaborated with State Street to answer this question. More specifically they set out to determine if, "firms with more positive public sentiment for the way they respond to the COVID-19 crisis and their effects on employees, suppliers and broader society will experience higher institutional money flows and outperform their counterparts during the market collapse". These factors

touch on the social and the governance components of ESG. While the research focuses on US equity markets we believe the findings can be applied to Canada as well.

In conducting their research they used machine learning and natural language processing to gauge sentiment on 1005 US-listed companies across thousands of news sources. To determine how institutional asset flows moved they leveraged internal data from State Street, which is one of the world's largest custodians with over US$34 trillion in assets under custody. The data concludes with two key findings that may help explain why companies with stronger social and governance factors have outperformed. The first is that companies that were viewed, "as protecting employees and taking action to secure their supply chain experienced higher institutional money flows and less negative returns". These actions have been especially heightened in the media in the midst of record unemployment and shuttering of businesses due to the pandemic. The results also purport that there was less an impact on institutional flows and performance on a firm's operating crisis response, which "could be explained by investors seeing such responses as idiosyncratic and not reflective of a company's resilience". Ultimately this shows ESG issues are moving well-beyond the focus on environmental issues. How businesses treat their employees is a key issue, not simply because its makes us feel good, but it can allow for a more productive workforce which can in turn transmit to higher profitability. Furthermore, that companies have been rewarded for taking action to secure supply chain networks is no surprise as many that have been stifled by disruptions within large and overly complex networks have the potential to not only realize lower current profits but also future profitability as less hampered competitors grab market share.

Key ESG Issues Looking Forward

When analyzing the risks that companies face through an ESG lens there have been several common issues. Environmental factors have long been at the forefront of ESG analysis, however in recent years there has been a rise in interest in corporate governance and social factors. For example, institutional investors in Canada note anti-corruption, shareholder rights and water as the three top ESG issues they're concerned about when making investment decisions. Below we can see what major institutional investors across Canada, the US and Europe/UK believed were the most important financially material ESG issues in 2019.

Variety of ESG Issues in Focus During 2019

Rank	Canada	US	Europe & UK
1	Anti-corruption	Cyber security	Climate change
2	Shareholder rights	Anti-corruption	Water
3	Water	Water	Renewable Energy
4	Executive Compensation	Health & Safety	Anti-Corruption
5	Cyber security	Renewable Energy	Biodiversity

Source: RBC Global Asset Management 2019 Responsible Investing Report
Blue shade = common among all regions, Yellow shade = common among at least two regions

Going forward we believe these issues will remain in focus, however economic and social trends are pointing to an increasing significance of other major issues. For example, with many companies being forced the lay off staff in the downturn we would expect executive compensation to be a key issue in the future. Median

economist forecasts from FactSet point to year end unemployment in the US and Canada at 9.2% and 8.8%, respectively. This is exacerbating concerns around rising CEO compensation, with research from US think-tank the Economic Policy Institute finding that the ratio of CEO compensation to typical worker is 278-to-1.

In addition, there will likely be a heavy focus on how companies manage their supply chain networks and manufacturing locations. Perhaps instead of simply finding the lowest cost regions to situate their various production processes and transportation hubs, investors will demand greater diversification. China's cheap labour and relaxed laws allowed the country to dominate the global trade seen since becoming a member of the World Trade Organization in 2001. Research from the Economist Intelligence Unit shows that China's share of global trade by volume is well over 50% in some industries, such as telecommunications. Multinational companies had already been shifting supply chains in light of the rising US-China trade dispute and many believe the impact of COVID-19 will provide more impetus to do so in order to hedge against potential shocks to their networks.

Conclusion

All said and done ESG appears to be here to stay, with evidence supporting its use in portfolio management mounting every day. While more analysis is warranted as the economic impact of COVID-19 continues to become clearer, we are encouraged by the positive trends that were already being realized in recent years. As such, whether your portfolio consists of individual equity and fixed income positions or you invest in managed money products ESG should be a part of your analysis. We caution against investing in any product or company simply because it has a high ESG rating or has the phrase "ESG" in its name. As we noted at the beginning of this report, ESG investing means utilizing environmental, social, and governance data to help make informed decisions, whether that be to mitigate risk or drive alpha. The key word is "help"; ESG is another tool in the tool belt to help investors but one we believe should be given consideration.

For more information on the rise of ESG investing and how to incorporate it within your investment framework please see the PCS Trends & Ideas article published November 1, 2019 (A Changing Investment Climate) and the PCS Managed Money Report published Fall 2019 (Investing Responsibly – Breaking Down the Myths About Socially Responsible and Environmentally Conscious Investing).

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