In the current market environment, littered with cryptocurrency trading, short squeezes and NFTs (non-fungible tokens), it is easy to lose sight of fundamentals, and fundamental values. The topic of responsible investing is one that many of us take to heart. We regularly receive emails and phone calls from our clients on the subject. Therefore, this month, we want to cover the concept of ESG (environmental, social and governance) factors in portfolio construction and management.

We have used ESG as a screening criterion in our security selection for our portfolios since 2012. We are believers in the science.

What is responsible investing

According to the United Nations-supported Principles for Responsible Investing the term refers to an investment approach that “aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable long-term financial returns.” Responsible investing involves the inclusion of environmental, social and governance (ESG) concerns in the management and selection of investments. ESG or responsible investing is the process by which an investor seeks to build a holistic portfolio of companies by identifying and managing the different exposure to the various ESG risks and opportunities that are not captured by traditional financial metrics and analysis but could be material to investment performance.

An ESG or responsible or sustainable investor aims to marry portfolio performance with a positive societal impact by aligning their investment goals with personal values and beliefs. This suggests that an ESG investment is both evaluated on its positive as well as its negative impacts in the various spheres of ESG. A values-based approach can include but are not limited to green investment, ethical investment, community investment, and impact investing.

Let’s look at the three components of this approach in turn.

The environment:

The environmental criteria measure the impact of a company’s activities on the planet in both positive and negative ways. A company that is an actively good corporate citizen with respect to the environment would be considered as a potential investment for an ESG portfolio.

Environmental aspects of a company:

• What carbon footprint and carbon intensity (pollution and emissions) is the company responsible for.
• What are its recycling impacts and safe disposal practices.
• Impact on climate change, and what policies relating to the environment are in place as well as future plans, including contribution to greenhouse gas emissions, targets (goals) and transparency about how the company is meeting those goals.
• Water-related issues: usage, purification, wastewater management, conservation, overfishing, and waste disposal.
• Usage of renewable energy, including wind and solar.
• Green products, technologies, and infrastructure, and their importance in terms of the overall company.
• Environmental benefits for employees, such as bicycle commuting rewards programs and environmentally based incentives.
• Historical and current relationship with government environmental agencies and other environmental regulatory bodies where the company operates. (special attention if the relationship is predicated on supervision due to bad behaviour).
• Geographic operations: Does the company operate in geographies where environmental concerns are important, or in geographies where it is easiest (cheapest) to operate with little environmental oversight.
• Etc.

Social impact:

The social component of ESG consists of people-related elements, like company culture and issues that impact employees, customers, consumers, suppliers, the local community, and society at large. This criterion adds a new dynamic to security selection, as it is not about growth or profits in the historic or traditional sense, but rather the effects of the company at a multitude of levels where it impacts the lives of those in the products and services chain, not just the consumer.

Social aspects of a company to research and analyze include, but are not limited to:

• Employee treatment, pay, benefits, and perks.
• Employee engagement and staff turnover/churn.
• Employee training and development.
• Employee safety policies, including those related to sexual harassment prevention.
• Diversity and inclusion in hiring and in awarding advancement opportunities and raises.
• Ethical supply chain sourcing, such as conflict-free minerals and responsibly sourced food and coffee.
• Mission or higher purpose (or lack thereof).
• Customer service friendliness and responsiveness.
• Performance history for consumer protection issues, including lawsuits, recalls, and regulatory penalties.
• Public stance on social justice issues, as well as lobbying efforts.
• Etc.

Corporate governance:

Corporate governance as it relates to sustainability refers to the strength and stability (not a revolving door) of the board of directors and their activities and policies. It also refers to the implementation of policies as well as the “philosophical” identity of the company. General oversight as well as broad shareholder centricity (as opposed to C suite favouritism) are all important elements in evaluating the strength of a company’s governance. It stands to reason that a company with good corporate governance and a strong board of directors relates well to different stakeholders, runs its business effectively, and aligns the management team's incentives with the company's success.

Governance aspects of companies:
• Executive compensation (pay increases), bonuses, option compensation and perks, including whether executives receive large bonuses when they leave the company.
• Compensation tied to metrics that drive long-term business value.
• Diversity of the board of directors and management team.
Potential for conflicts of interest for the board of directors based on the directors’ independence and whether they hold other board seats.

Proxy access, meaning shareholders’ ability to put forth board of director candidates.

Whether a company has a classified board of directors, which denotes whether term lengths among board members differ.

Whether the company’s chairman and CEO roles are separate.

Whether board votes are decided based on majority voting (winner receives more than half the votes) or plurality voting (winner receives the most votes).

Whether the company issues dual- or multiple-class stock.

Transparency of communication with shareholders.

The nature and outcome of lawsuits brought by shareholders.

Relationship and history with the U.S. Securities and Exchange Commission (SEC) and other regulatory bodies.

Etc.

The above aspects of different elements to evaluate in each of the three components represents a concise list of criteria. Now the question remains: HOW to assess companies based on the above criteria?

There are several tools available for the do-it-yourself ESG investor. For example, for information on a company’s social performance and philosophy, two organizations that provide reporting from a sustainability perspective come to mind: GRI (Global Reporting Initiative, GRI was founded in Boston in 1997 following public outcry over the environmental damage of the Exxon Valdez oil spill) or PRI (Principles for Responsible Investments). These two organizations are largely independently funded, which makes them objective, and both provide information which goes beyond environmental issues to include information pertinent to employees, suppliers, and the community.

Socially minded investors can also keep up with respected lists and annual rankings, including Fortune’s “Best Companies to Work For” and Forbes’ “Just 100”. Media reports on how companies treat their employees and the companies’ lobbying efforts for or against social justice issues are also relevant. Another good way to gauge how a company and its management is received by its workers is to read employee reviews on websites such as Glassdoor, Indeed, Vault, and career bliss to name a few. Otherwise, there are subscription services that provide analytics that are used to evaluate on both an absolute or relative basis. Some of these are YourSRI, Arabesque and Sustainalytics, a service which we use. While all three of these are subscription services, they do have some free tools that are interesting, and offer a primer in terms of ESG investing.

There is also the route of using marketed ESG mutual funds and ETFs. We caution you about these, as they are often not as pure as they seem, and if the ESG decision is fundamental to you, these would not be a solution we would recommend.

Having looked into what ESG (and its synonyms sustainable investing and responsible investing) is, and how companies are measured (in part, as there are a multitude of offshoots and depths), there is the question of what it means to your portfolio.

As the definition states, ESG is the responsible way to behave. It is responsible in terms limiting the impact on the environment, it is the responsible and respectful way of treating people, and it is ethical and fair (more oversight in terms of how the C suite behaves).

While all of these are true, there is also a capitalist argument for being an ESG investor. As I mentioned previously, we chose to apply an extra filter to our model since 2012 in an effort to eliminate bad corporate citizens. But we discovered that there are significant benefits in terms of better financial
results.

The body of evidence suggesting that material ESG factors applied into investment analysis and portfolio construction, offers investors potential long-term performance advantages, both in terms of finding better performing companies (Nike, when they brought in corporate governance), and very importantly, avoiding names that may run into trouble and suffer for it (think BP before the oil spill of 2010 and Volkswagen pre diesel gate in 2015). ESG factors offer investors added insight into the quality of a company's management, culture, risk profile and other characteristics. By considering material ESG issues in the investment process, investors may achieve a holistic approach to investing as well as market rate returns or above. Here are several characteristics that exist in strong ESG compliant companies.

- A stronger brand and greater pricing power
- Greater operational efficiencies
- More efficient use of resources
- Supply chain optimization
- Lower costs
- Enhanced ability to attract, retain and motivate employees
- Greater employee productivity
- Improved customer loyalty
- Enhanced ability to enter new markets
- New potential sources of revenue
- Lower market, balance-sheet and operational risks
- Lower costs of capital
- Greater access to capital, financing and insurance

Without going into detail, I believe it is accurate to state that ESG is here to stay, and will continue to gain traction in portfolio construction, and in corporate behaviour. But there are a few latent issues that can make the screening imperfect. As an example, perhaps we can use a hypothetical pipeline company, one seeking to receive permitting for a coast-to-coast pipeline. There are clear lines that are being crossed in terms of bad corporate behaviour regarding this scenario: 1- Environmental impact due to the construction; 2- Social impacts from crossing into heritage and indigenous territories; 3- The industry itself, transport of fossil fuels, and the impact on the environment from production to refining, commercialization and use. All of these points are extremely valid. But to be a devil's advocate, how do we measure the “benefits” of such a project: In no specific order: Employment: the creation of jobs certainly satisfies a social criteria, particularly if it includes training and ownership (to some extent) of the project in indigenous territories; 2- While fossil fuels are bad for the environment from start to finish, we are reliant on them. It will take time to ween off them. As such, we will, as a society, continue to use fossil fuels, and as such, transportation is required. As the populace of Lac Megantic can attest to, pipelines are far safer than rail transport, and far less polluting when in use than tanker trucks. So, it is a question of the lesser evil...

We site this example not because we feel that pipeline companies do not get a fair shake, not at all. It is just an example of some of the conflicts that can arise from an in-depth analysis of these companies, when presented on a relative basis, which we feel is important. In our conversations with our clients on this subject, the initial reaction or stance can be that bad companies (or ones that do not qualify because they are not perfect in all respects of what they understand of ESG) are bad companies, end of story. The question that remains is should there not be, from an objective perspective, some measure of
encouraging those corporate citizens who are evolving into good corporate citizens. Or is ESG an absolute.

We believe that there is a line between the two, that companies attempting to re-align with ESG standards of practice should be encouraged, in certain cases. We also believe that many things perceived as good ESG companies because they serve as an alternative to old “bad corporate citizen” companies. An example of this is Beyond Meat. They are perceived as an environmental champion, of sorts, as they present an alternative in the food world. But truth be known, they are a poor ESG choice as they have a number of issues (based on the research and analytics from Sustainalytics) that results in a severe risk rating. The point is not to pick on any one company, but to highlight that perception and reality are not one and same, and that proper ESG filters need to be researched and understood.

Our view remains favorable to the use of ESG as a determinant in portfolio construction. It is an effective tool that helps confirm quality companies for inclusion in our portfolios, as well as helping us detect certain failings in corporate names that fundamental analysis would have missed.

As always, we welcome your questions and comments.

Erik and Guillaume