RESPONSIBLE INVESTING:

Putting Your Money Where Your Values Are

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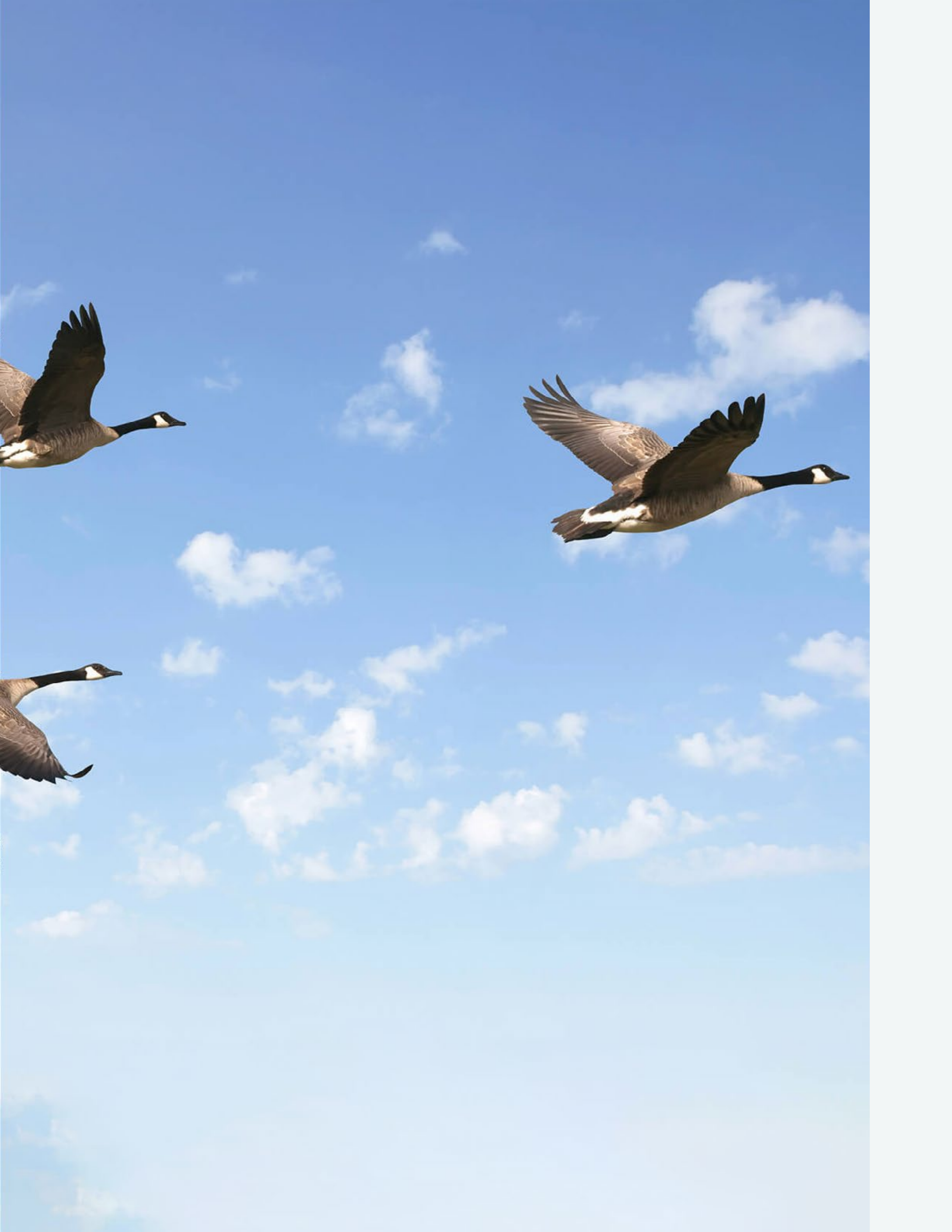


Introduction

A growing number of Canadians want the way they invest their money to align with their personal values. They want to know the companies they invest in pay attention to the impact they have on the environment and their employees and communities, and that they are making decisions in an ethical manner.

The result has been a rapid increase in the importance of responsible investing for both institutional investors, such as pension funds, and individuals saving for their retirement. They are part of a worldwide movement.

Globally, there is **US$23 trillion of assets** being professionally managed under responsible investment strategies, according to the Global Sustainable Investment Alliance.

QUESTIONS

However, many people who are considering moving their savings into responsible investments—and even many who have already done so—have questions about this style of investing.

What makes an investment responsible?

Do I have to give up returns?

How can I be sure my investments truly reflect my values?

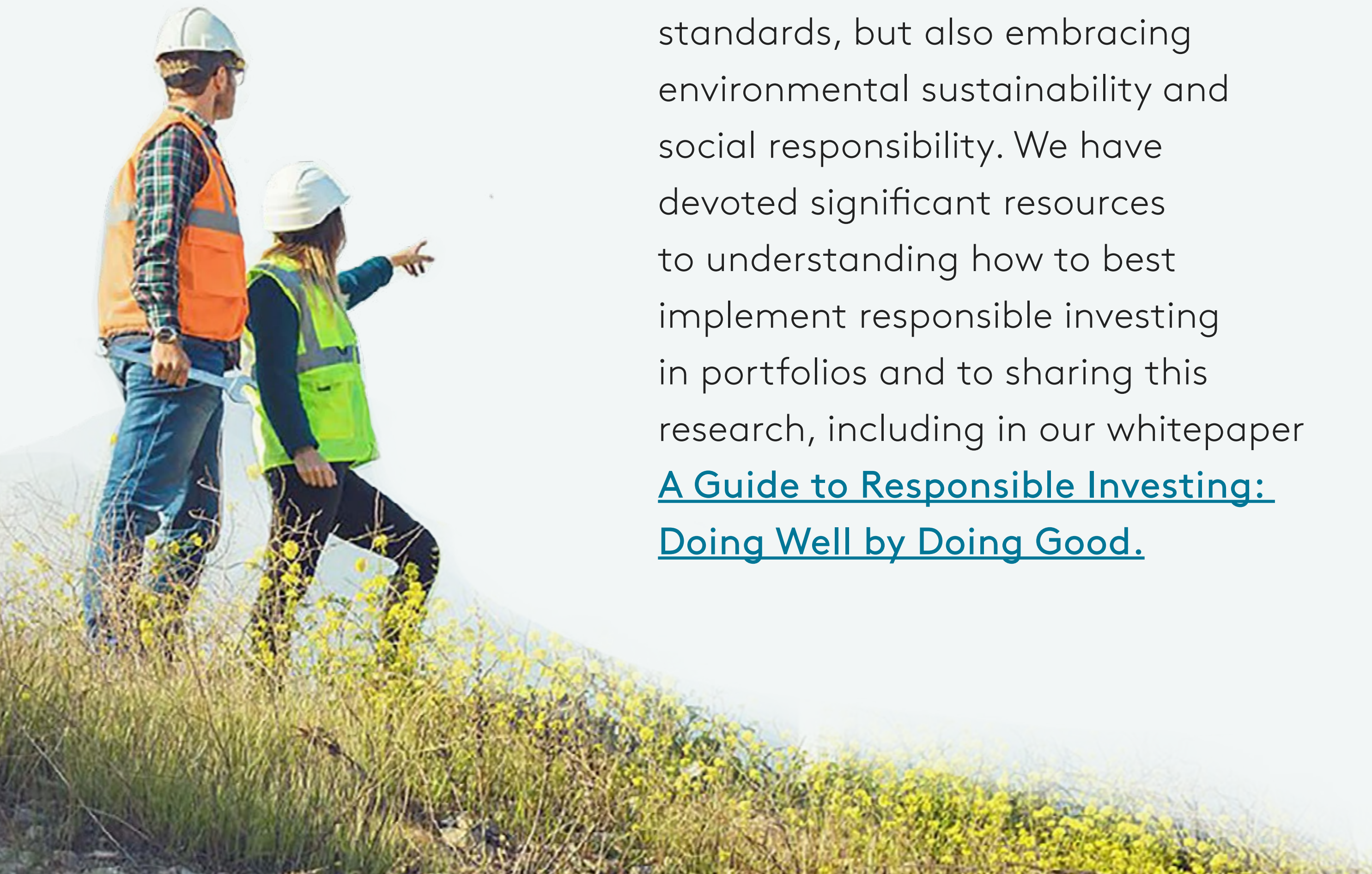
Can I maintain an adequately diversified portfolio and control my risk?

Does responsible investing make a difference?

At PWL, we have long championed an **evidence-based approach** to investing, relying on scientifically proven principles to build portfolios that capture maximum risk-adjusted returns. In recent years, we have added the concept of **values-based investing**, while still ensuring all our portfolios remain anchored on sound evidence-based principles.

Our commitment to values-based investing

The term values-based investing reflects our commitment to supporting clients who decide to make responsible investing a priority. At PWL, we believe in the importance of not only adhering to the highest ethical standards, but also embracing environmental sustainability and social responsibility. We have devoted significant resources to understanding how to best implement responsible investing in portfolios and to sharing this research, including in our whitepaper A Guide to Responsible Investing: Doing Well by Doing Good.



WHITE PAPER

A Guide to Responsible Investing – Doing Well by Doing Good by Raymond Kerzérho, Peter Guay and Marc Brodeur-Béliveau

Responsible investing can be a surprisingly complex and often confusing subject. This eBook is designed to answer your questions and help you make decisions that are right for you.

Understanding the responsible investing landscape

While almost all investors consider themselves to be acting responsibly, those who are identified with the term "responsible investors" specifically seek to promote positive environmental, social and ethical corporate behaviour while still meeting their financial goals. They choose not to support businesses deemed to have a negative impact on the environment and society and embrace those demonstrating superior performance in these areas.

Is a company focused on reducing carbon emissions and other pollution? Does it treat its workers fairly and ensure its suppliers do too? Is it working to ensure gender, racial and LGBTQ diversity and equality? Does it have high governance standards and operate with integrity? These are the kind of questions that responsible investors ask.

For many individual investors, the decision to choose responsible investments comes down to a simple question: If I wouldn't work for a company, or buy their products, why would I invest my savings in them? Or, to put a positive spin on it: If I'm concerned about making the world a better place, shouldn't I use my money to help make it happen?

CLARIFYING THE TERMS

As interest in responsible investing has grown so too has the number of terms being used to describe it, and the number of strategies being used to implement it.

There are several terms, some of which are used interchangeably.

Environmental, social and governance (ESG) investing

Socially responsible investing (SRI)

Impact investing

Ethical investing

Sustainable investing

Responsible investing is the umbrella term used by many in the investment world and ESG is a framework within it. ESG has gained wide usage in the investment world, and that's the term we will use in rest of this eBook.

Measuring sustainability

Environmental, social and governance (ESG) investors can either exclude, include or reweight companies in a portfolio in response to how that business scores on a range of key performance indicators (KPIs). The complexity comes when investors try to objectively decide what KPIs should be evaluated, what relative importance they should be given and how companies are performing on them.

A key challenge for ESG investors has been the lack of standardization in the way companies report on their performance. Some observers say many ESG investment funds have also been guilty of a lack of rigour in how they evaluate companies. This has led to concerns about greenwashing—companies and fund mangers talking a good game but not living up to their sustainability claims.

To address this issue, the international Sustainability Accounting Standards Board (SASB) introduced last year 77 industry-specific accounting standards for reporting on financial risks related to sustainability. Elsewhere, the Global Reporting Initiative (GRI) has produced a set of global standards for sustainability reporting by businesses and governments.

In parallel with these and other initiatives, the Corporate Reporting Dialogue launched in late 2018 a two-year project to align sustainability reporting frameworks with the participation of key standard setters and framework developers, including SASB, GRI, CDP (formerly the Carbon Disclosure Project), and the Climate Disclosure Standards Board.

Does ESG investing make a difference?

With trillions of dollars pouring into ESG investments, the pressure is on for both investment managers and companies to show real, verifiable results, while still meeting their financial goals.

The world is a big place and it's a monumental and complex task to measure the impact of ESG investing. Nevertheless, there are many positive signs that responsible investing is creating change, notably in support of the UN Sustainable Development Goals and the Paris Agreement on climate change.

78% of the companies in the S&P 500 index now issue a sustainability report, most with environmental and social performance metrics, according to 2018 research by the Sustainable Investments Institute.

Worldwide, about **3,700 large and mid-size companies** issued corporate responsibility reports, according to the KPMG Survey of Corporate Responsibility Reporting 2017.

There are numerous examples of large corporations from Walmart to mining giant Glencore changing their behavior in response to investor and consumer concerns about their impact on the environment and society.

How do ESG investors work?

Investors use different ESG strategies ranging from relatively passive to highly active.

Large institutional investors such as State Street, Vanguard and BlackRock have adopted stewardship policies that cover even their most broad-based, passively managed funds, such as the ones replicating the performance of the S&P 500.

These investors use their power as major shareholders to have discussions with companies on ESG-related areas of concern that might increase the risk profile of their funds.

Then, they decide how to vote on ESG-focused shareholder proposals. For example, Sate Street, Vanguard and BlackRock voted in favor of a resolution that required energy giant Exxon to report on the financial impact that climate change could have on the company.

ESG strategies

A step above this level of engagement are investors who actively manage portfolios on the basis of ESG criteria.

Impact investing

Integration strategies

How do ESG investors work?

ESG strategies

SCREENING STRATEGIES

In past decades, the emphasis of active ESG investing was primarily on excluding companies, or whole industries, that failed to meet pre-established sustainability and responsibility criteria. Industries such as tobacco, alcohol, pornography, gambling, weapons and firearms manufacturers, and fossil fuel producers were often excluded.

More recently, positive or best-in-class screening has been added to the mix. Investors not only screen out bad actors but seek to include good ones—companies that score well on environmental, social and governance metrics.

This screening encompasses a company's record as well as whether it has adequate monitoring and strong governance to ensure high standards of environmental sustainability, respect for human rights, promotion of diversity and the prevention of corruption.

IMPACT INVESTING

Many ESG investors actively work to influence the behaviour of companies in an effort to make them greener and more socially responsible. They do this by engaging with the companies, proposing shareholder resolutions and participating in public pressure campaigns.

A small but growing subset of active investing is known as impact investing. Besides engaging in shareholder activism, these investors make targeted investments with the goal of solving environmental or social challenges.

ESG strategies

INTEGRATION STRATEGIES

Here, investors don't necessarily screen out companies for undesirable behaviour. Instead, they seek to integrate ESG criteria into investment decisions, reweighting portfolios based on the ESG ratings assigned to companies by third-party research outfits, such as MSCI Inc. These research providers have elaborate methodologies for evaluating how sustainable and responsible companies are relative to their industry, and whether or not their performance is improving.

ESG scoring on the same companies can produce conflicting conclusions, depending on the research methodology used. That's why increasingly institutional investors use multiple sources of data.

How do ESG investors work?

Options for every concern

As the popularity of ESG investing has grown, asset management companies have branched out from broad-based funds to offer niche products that allow people to channel their savings to support particular causes—solar power, gender diversity or minority empowerment, for example. There are now well over 200 ESG exchange-traded funds available to the investing public.

Do ESG investors sacrifice returns?

There's a growing academic consensus that investors don't have to give up returns to hold a portfolio of ESG investments. Our analysis of the wide body of research on the topic has led us to the conclusion that, if executed properly, an ESG portfolio will likely have a similar risk-return profile as a non-ESG portfolio.

These findings contrast with earlier research that supported a widely held belief that responsible investing came at a price in terms of foregone returns. This theory held that premium returns were provided by so-called sin stocks such as tobacco, alcohol and gambling. Sin stocks were thought to outperform precisely because they were shunned by many institutional investors and could be had at lower prices, even though they were often highly profitable.

Subsequent research disproved the theory that sin stocks produced better returns than other stocks. However, a problem remained—diversification was lost when sin stocks were excluded from an otherwise broad-based portfolio, creating a higher risk of underperforming the market.

Enter the concept of ESG integration. As explained earlier, an integration approach doesn't necessarily exclude poor ESG stocks but instead underweights them in favour of stocks with better ESG performance. More than 50 studies between 2008 and 2011 came to the consensus that by using this methodology, one can create a well-diversified ESG portfolio, free of negative risk-return characteristics.

Do ESG investors sacrifice returns?

What's more, recent studies have found that companies with strong ESG practices generate better financial performance than their peers. While more research is needed, the studies suggest these companies operate more efficiently and are buffeted less often by value-destroying scandals involving environmental disasters, corruption, labour strife or other issues. BlackRock, MSCI and Dimensional Fund Advisors all have data to show the outperformance of ESG funds compared to their own non-ESG-focused offerings.

THE BOTTOM LINE?

Evidence is growing that ESG investors can have their cake and eat it too. They can align their portfolio with their values and still earn risk-adjusted returns that are similar to those from a non-ESG total market portfolio.

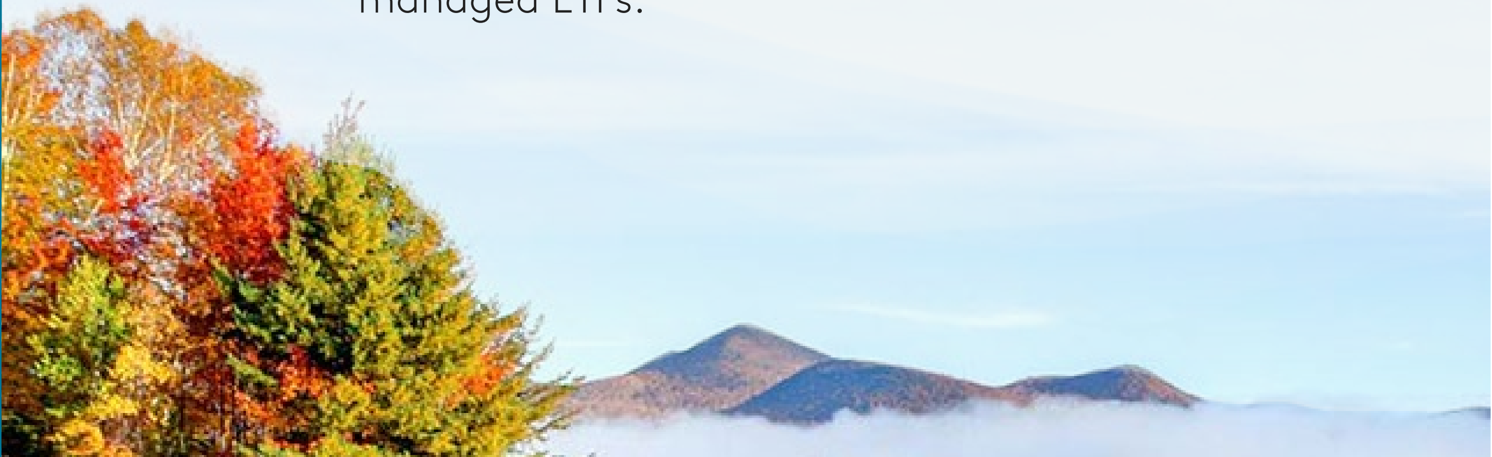
Do ESG investors sacrifice returns?

A model ESG portfolio

PWL capital believes the best route to wealth creation and preservation over the long term is to invest in passively managed portfolios that offer the widest possible diversification.

This evidence-based philosophy has guided us in developing our approach to values-based investing. That's why our model portfolio is based on an integration approach to ESG investing that balances return/risk and ESG impact objectives.

PWL's model portfolio follows our investment philosophy by covering the total equity market, diversifying globally across a very large number of stocks. To achieve this, it uses low-cost, passively managed ETFs.



CANADIAN FIXED-INCOME

50% iShares ESG Canadian Aggregate Bond Index ETF
(Ticker: XSAB, MER 0.18%)

50% iShares ESG Canadian Short-Term Bond Index ETF
(Ticker: XSTB, MER 0.18%)

CANADIAN EQUITY

100% iShares ESG MSCI Canada Index ETF
(Ticker: XESG, MER=0.20%)

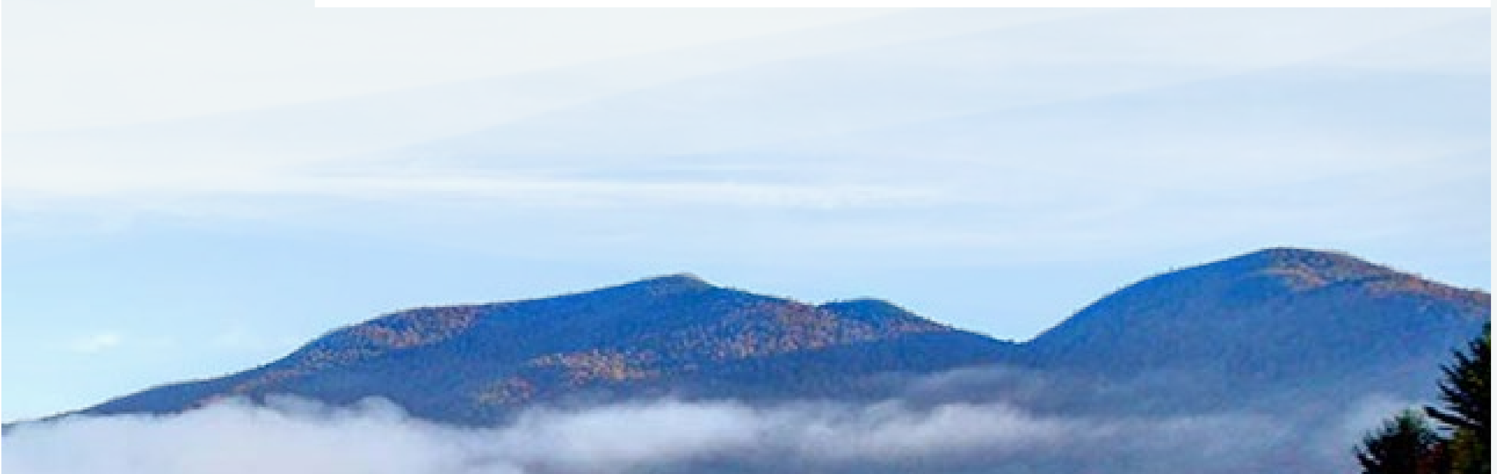
U.S. EQUITY

100% iShares ESG MSCI USA Index ETF
(Ticker: XSUS, MER=0.25%)

INTERNATIONAL EQUITY

70% iShares ESG MSCI EAFE Index ETF
(Ticker: XSEA, MER=0.30%)

30% iShares ESG MSCI Emerging Markets Index ETF
(Ticker: XSEM, MER=0.35%)



Conclusion

A growing body of evidence indicates that ESG investments provide similar risk-adjusted returns than their non-ESG counterparts. This evidence—combined with the concern many people feel about the challenges facing the world—has made responsible investing a more attractive option than ever. We can see this by the flood of money pouring into ESG-focused investments worldwide.

It's always made sense to invest with consideration for the environment, social values and high ethical standards. Now, this idea is supported by statistical evidence, and that's very good news for investors and the world.

We understand responsible investing is not for everyone, but we believe it's a great option for many people. If you're interested, come and see us. We can help you use your investments to make a difference in the world while still achieving your personal financial goals.

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This paper was written by Peter Guay, Anthony Layton, Raymond Kerzérho, PWL Capital Inc. The ideas, opinions, and recommendations contained in this document are those of the authors and do not necessarily represent the views of PWL Capital Inc.

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