Quiet Counsel

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Investment Outlook

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Lifting the Fog on ESG

Over the last 15 years, responsible investing has grown dramatically in size and scope, with signatories to the Principles for Responsible Investing (PRI) surging past 3,000 and representing over US$100 trillion in assets under management. With the explosion in environmental, social and governance (ESG) investing, many new strategies have emerged to meet the increased demand. In Canada, net inflows into ESG-themed exchange-traded funds (ETFs) have reached $740 million this year alone, and 15 new products have been launched.

With that growth has come complexity. While many funds now carry the "ESG" label on them, many investors are confused about what strategy they are actually invested in. In this article, we will provide clarity on the different responsible investment options out there to ensure that investors understand the differences, help them assess whether their current portfolio aligns with their investment goals, and highlight Leith Wheeler's history applying ESG principles to our own investment process.

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ESG is Not Just a Single Concept

Generally, there are three broad approaches under the responsible or ESG investment umbrella: Values-Based or Socially Responsible Investing, ESG Integration, and Impact Investing. Within each bucket there are several different strategies one could follow.

Values-Based or ***Socially Responsible Investing (SRI)*** aligns a portfolio to a specific set of values or beliefs. Commonly referred to as **negative screening**, it involves excluding investments that don't meet certain criteria. Over the years, as new issues have emerged, the list of industries in investors' crosshairs has grown from alcohol, gambling, pornography, and tobacco to include fossil fuels, nuclear energy, weapons, and others.

While negative screening might seem relatively straightforward, different approaches can produce sometimes surprising results. Take fossil fuels for example: a quick search of the eVestment database for global equity products that exclude fossil fuel investments yields 125 funds that meet the criteria, 59 of which had some exposure to the Energy sector. This result is likely due to the distinction between screening out companies that *own* fossil fuel reserves – which would exclude oil and gas producers – versus those companies that *provide services* to the industry, such as pipelines.

ESG Integration refers to the assessment of material ESG risks and opportunities alongside traditional financial analysis in the investment process. It is a broader approach that does not prohibit investment in any specific sectors or industries, but an investment manager might come to that conclusion if, for example, it determined the ESG risks at a company were too high and therefore might impact the expected returns. Often, managers using integration approaches will invest in companies they've determined to be leaders in their management of ESG issues, and use active ownership practices to engage with companies to encourage ongoing improvement.

Finally, **Impact Investing** targets investments that promise to provide both a financial, and lasting positive social or environmental impact on issues such as climate change, education, or poverty. For example, in fixed income markets, "green" bonds are issued to fund projects such as clean transportation (public transit), clean energy, and land management. But there can be confusion here as well, as varying definitions of what constitutes a "green" project exist. For example, a nuclear power project may qualify for funding due to its low emissions, despite the serious environmental risks it carries in case of an accident. (For more information on green bonds, see our recent article in Canadian Investment Review.)

Determining the Right Strategy

The starting point for any investor wanting to reflect a responsible investing approach in their portfolio is to define their ESG goals and objectives. Key questions to ask include:

- Is there a mission, value, or belief that you want to govern your manager's investable universe?
- Are your goals broad-based or more customized?
- Do you require absolute exclusions of screened-out names or sectors, or are you open to a sliding scale to permit proactive engagement with companies?

Clarifying the answers to these types of questions up front will help you identify which approach best aligns with your goals.

If you adopt an approach that excludes certain investments, have clear policies in place to minimize confusion. For example, if you do not want to own companies with "significant exposure to industry XYZ," be sure to define "significant" and what "exposed" means. If

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you're trying to reduce your carbon footprint, do you want to exclude companies that just own fossil fuel reserves (producers), or does this also extend to companies that provide services to the industry (pipelines)?

When determining significance, you should weigh your SRI goals with the impact of such restrictions on the investment universe and the manager's ability to achieve attractive returns. These were the types of issues we looked at when we created our **Leith Wheeler Carbon Constrained Canadian Equity Fund.** We believed that investors who wanted to eliminate fossil fuel investments would also want to eliminate companies that derive the majority of their revenues from the industry, so we established a 30% threshold on revenues to define significant involvement.

If you have broader ESG goals that include your manager considering these factors in their evaluation of investments, an ESG Integration approach likely works best. Because of the complexity of the issues involved, the use of passive funds (i.e., index funds or ETFs) to achieve your goals here warrants some caution. Many ETFs rely on a single, third-party ranking to identify companies for fund inclusion but this approach can be problematic as there are often material differences in the ratings or scores between the various providers. A company can also be assigned a lower score simply because it doesn't publicly disclose its ESG policies, which unfairly penalizes smaller companies.

Conversely, an active manager who follows this approach will typically use many techniques and sources to assess a company's ESG practices, from company reports and discussions with management teams, to a variety of third-party research.

Leith Wheeler's Integration Approach

Fundamental research discipline

Assessing the quality of management is a key part of our process, as we find that companies with strong leadership who are good stewards of capital, are also committed to doing right by their employees, their communities, and the environment. Owning large shareholdings on behalf of our clients also enables us to engage meaningfully with management and communicate our expectations regarding their ESG practices. Many of our long-term holdings are companies we admire and trust, such as Saputo, with its commitment to employees, and the safety and quality of their products, and Toromont Industries, with its strong safety culture.

Engaging directly with companies

Our team believes that a company's **safety culture is critical** to long-term value creation, so every meeting with management includes questions such as:

- What is your safety record?
- Who is responsible for safety?
- How are they compensated?

Management's responses to these questions tell us a lot about the importance the company places on safety and how it treats its employees. If a company's CEO can't answer one or more of these questions, we treat it as a red flag. Compensation strategy can also serve as a differentiator between competing stocks: two leading Canadian companies measure safety achievements on injury and accident rates, for example – implying one values the *human* cost of safety lapses, and the other solely the financial one.

We also **lobby companies directly to achieve higher female representation** on their boards. In 2015, we conducted an audit of our holdings to determine their success on this metric. Since then, we've regularly asked management teams to do better – and the average percentage of women on the boards of our companies has risen from 18% to 31%. Today, over half of our holdings have greater than 30% female directors, and every company has at least one. One example that stands out is Mullen Group, which moved from zero to two women in a single year.

Advocating for client interests

At Leith Wheeler we have a long history of fighting – in the courts, when warranted – for our clients' interests. We contested the takeover of pulp and maker producer **Crown Zellerbach Canada** when its parent tried to buy out the minority interest at a too-low price, and did it again to get a better deal for clients when paint maker **CIL**'s

parent attempted the same. In the CIL case, we spent a significant amount our own funds on legal fees and expert witnesses on behalf of our clients and co-founder Murray Leith spent months crafting the legal response. It eventually ended with a deal on the courthouse steps and a nice gain for our clients.

We similarly went to bat for clients when **Pacific Western Airlines** reorganized, and when **Petrokazakhstan** was struggling, we also stepped in. Hard negotiations and a fortuitous jump in the price of oil eventually resulted in our clients selling their stock at significantly higher levels.

Our involvement with **Blue Range Resources** had a more lasting impact on the oil patch. We were active investors, and put an emissary on the board to try to right the ship – which ultimately proved unsuccessful as the company went under and was charged by the Alberta Securities Commission with failing to disclose material facts. Co-founder Bill Wheeler testified in those hearings, which ultimately **brought real change to the way oil and gas companies report reserves in Canada.** These changes increase the confidence that investors have in the transparency of oil company reserves and help keep Canada a leader in market integrity.

Our independence allows us to take up these fights. Unconstrained by competing priorities that can sometimes crop up within larger organizations, we can focus on doing what's right for our investment management clients.

We've only just scratched the surface here of an evolving area of the investment world. As investors increasingly turn to their investment portfolios as a means of reflecting their values, the popularity of ESG strategies will only grow. By taking the time to first understand the nuances of the options available, they will be better able to achieve their goals – both financially and personally.

IMPORTANT NOTE: This article is not intended to provide advice, recommendations or offers to buy or sell any product or service. The information provided is compiled from our own research that we believe to be reasonable and accurate at the time of writing, but is subject to change without notice. Forward looking statements are based on our assumptions, results could differ materially.

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