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AGF INSIGHTS

INVESTING

What is Sustainable Investing?

What began as a niche desire by investors to put their money where their heart is, has matured into growing agreement that the integration of environmental, social and governance (ESG) factors into investment strategies can improve the planet and social outcomes, while importantly driving long-term value for shareholders.

Sustainable investing or responsible investing refers to investment strategies that consider ESG issues as part of the investment decision-making process. In contrast, traditional investment strategies have limited or no focus on incorporating ESG factors into the investment process.

Examples of environmental, social and governance factors include:

Climate Change

Community Relations

Gender Diversity

Water Scarcity

Supply Chain

Executive Compensation

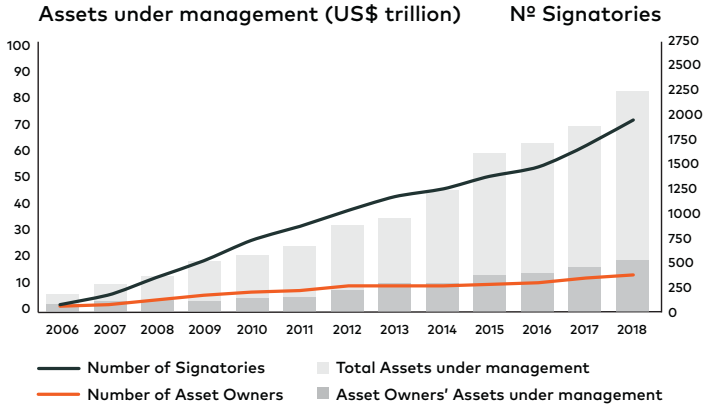
Interest in responsible or sustainable investing has increased substantially over the last decade around the world and across all audiences, from individual, retail investors to the largest institutions. Global responsible investment strategy assets now total approximately $31 trillion USD, an increase of 34% since 2016[1].

[1] "2018 Global Sustainable Investment Review," Global Sustainable Investment Alliance.

A number of factors contributed to the rapid growth of assets including:

- A greater public interest in ESG issues
- A greater understanding of the connection between different sustainable approaches, objectives and performance

The United Nations-supported Principles for Responsible Investment, an international network of asset managers representing some US$80-trillion worth of investment, has helped lend credibility to the merits of these investment approaches, bringing awareness and educating investors on the importance of considering E, S and G factors.

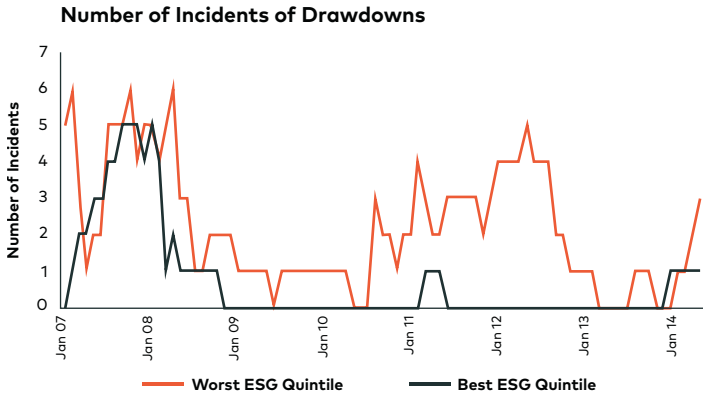


Source: UN PRI, as of June 2018

In response to the increasing interest, investment management teams, strategies and products have rapidly evolved, as have the data and tools available to evaluate these functions. A wide spectrum of approaches and products has developed ranging from mainstream investment management teams beginning to consider ESG issues to highly specialized impact strategies.

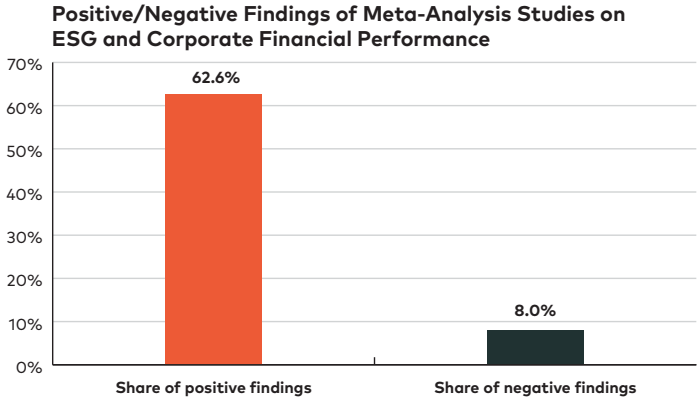
Recently, research has validated the spectrum of approaches, demonstrating that sustainable investing approaches can not only support but also provide added value to traditional objectives.

The consideration of environmental, social and governance factors have shown to help reduce exposure to risks and mitigate drawdowns in a portfolio. In research done by MSCI, when ranking the MSCI World Index by ESG score, the bottom 20% of ESG stocks experienced drawdowns three times more often than the top 20% of stocks.



Source: MSCI World Index, January 2007 to May 2017. Note: MSCI uses a full three-year look-ahead window in reporting results. For each month, MSCI reports the number of stocks that realized a more than 95% cumulative loss over the next three years, taking the price at month end as the reference point for the return calculation. Thus, the last data point is from May 2014, you cannot invest directly into an index.

As well, research has also demonstrated a relationship between a company's ESG score and financial performance. A meta-analysis of over 2,000 empirical studies over the last 50 years, found that research had demonstrated a positive correlation between a company's ESG performance and corporate financial performance 62% of the time[2].



Source: Friede, Busch, Bassen as of December 2015

The rapid evolution of sustainable investing has however potentially led to a gap in general understanding, a blurring comparison of strategies with unique objectives and concerns related to 'greenwashing'.

[2] Source: Friede, Busch, Bassen as of December 2015

Within sustainable investing there are a wide range of approaches with significant differences in investment objective and purpose:

Sustainable Investing Approach	Exclusionary Screening	ESG Factor Integration	Shareholder Engagement	Thematic Investing	Impact Investing
Definition	Excludes companies, sectors, or countries based on ethical, moral or religious beliefs.	Combines ESG data, research and analysis together with traditional financial analytics in the investment decision-making process. May not explicitly exclude investment in undesirable countries, companies, etc.	Uses the power of shareholders and stakeholders to directly or indirectly influence corporate behavior.	Invests in sustainable businesses that are related to and likely to benefit from specific impact themes (e.g., energy efficiency, green infrastructure, clean fuels, low-carbon transportation infrastructure, etc.)	Investments made into companies, organizations, and funds with an intent to generate a measurable, beneficial social and/or environmental impact alongside a financial return.
Purpose/ Objective	Eliminates exposure to a group of securities while generally pursuing a traditional investment objective (e.g., growth, income, etc.)	Incorporates ESG risks into analysis of all holdings, as a component of financial risk generally with two primary objectives, to reduce risk or improve performance alongside pursuing a traditional investment objective (e.g., growth, income, etc.)	Influence corporate behaviour in order to move forward an issue related to environment, social or governance initiatives. Engagement and shareholder activism may or may not be incorporated into a strategy's investment objective.	Provides investors exposure to a specific theme, linked to one or more issue areas where social or environmental need has the opportunity to create growth opportunities.	Focus on generating a measurable impact in one or more issue areas where social or environmental need may require some financial trade-off.
Performance Impact	Exclusionary screens can have a smaller or more significant impact on performance relative to a traditional strategy or benchmark due to the magnitude of exclusions which can encompass entire countries, sectors, industries or companies.	Research has demonstrated integration has a positive impact on long-term performance due to the emphasis on managing risks related to ESG issues and their potential impact on long-term performance.	No direct performance impact explicitly related to engagement or shareholder action however may have an indirect, positive impact due to actions individual companies may take in response to engagement in managing long-term ESG risks	Expectation that performance will align with or exceed the broad performance of companies in the industries isolated. Performance may differ significantly from broad benchmarks due to the more narrow focus. Additional performance measurements related to impact may be introduced.	Strategies are generally measured by the specific impact of the portfolio aligning to its' objective. Traditional performance measurements are often secondary or may even be irrelevant to impact-first or 100% impact strategies.

When determining the type of investment approach to consider, investors should attempt to clearly define their objective.

Objectives can range from:

1. a belief that select ESG factors may materially impact the value of the security owned and thus warrant consideration;
2. an investor looking to satisfy values preferences, necessitating the exclusion of investments that do not align;
3. an investor looking to create a meaningful impact towards a beneficial environmental, social or governance change.

Who should consider these different approaches?

Sustainable Investing Approach	Exclusionary Screening	ESG Factor Integration	Shareholder Engagement	Thematic Investing	Impact Investing
Investor Profile	Suitable for investors who have expressly stated a need or desire to take an exclusionary approach	Appeals to and is well suited for investors who aim to achieve the expressed investment objective and also investors expressly interested in considering environmental, social and governance factors when investing	Appeals to and is well suited for investors who aim to achieve the expressed investment objective	Suitable for any investor aiming to gain exposure to the growth potential of a particular theme	Suitable for investors aiming to generate a measurable, beneficial social and/or environmental impact that aligns with their ethics alongside a financial return.

Within each sub-set of approaches, the challenge of comparing managers and strategies to each other remains a significant hurdle. Although frameworks are being established to allow potential investors to more easily evaluate the merits of each investment management team and the results of their approach, further work needs to be done to broaden the measurement of results from traditional performance measures to include results related to sustainability objectives.

For example, a major challenge to measuring the environmental impact of a portfolio remains that the data is reported differently by many companies, even within the same sector, and its robustness can be questioned given the lack of third-party validation. Reporting on a single-factor, such as carbon emissions, is more common, however, other important factors like water use, land management and toxic emissions are less prevalent, limiting an overall sense of the company's environmental footprint.

Asset managers who wish to attain more information on a company's ESG policies can engage ESG ratings agencies to assess them and assign an ESG score. While these assessments do make it easier to compare similar companies, the rating agencies acknowledge that the process has flaws. ESG scores are only as good as the data and methodologies used to determine them and often rely on non-standard, self-reported data.

Significantly more work can be done by asset managers to encourage the companies that they invest in to consider and report on ESG issues, and also to provide more information on their own sustainable investing approach and the research they use to make decisions.

At the forefront of the sustainable investing movement, to encourage better corporate disclosure, European authorities have introduced a set of proposals, "The Action Plan on Financing Sustainable Growth"[3] aiming, amongst other initiatives, to set standards for transparency when

[3] http://europa.eu/rapid/press-release_MEMO-18-3730_en.htm

asset managers market products as "sustainable" or "green" to ensure comparability between products and discourage misleading claims.

Specifically, the proposals aim to:[4]

- Provide clarity by creating an EU-wide classification system to provide businesses and investors with a common language to identify what degree economic activities can be considered environmentally-sustainable.
- Ensure that asset managers, institutional investors, insurance distributors and investment advisors include environmental, social and governance (ESG) factors in their investment decisions and advisory processes as part of their duty to act in the best interest of investors or beneficiaries.
- Further, asset managers and institutional investors who claim to pursue sustainability objectives would have to disclose how their investments are aligned with those objectives. This means greater transparency towards end-investors, ensuring comparability between products and discouraging 'green-washing' or misleading information.
- Ensure that investment firms and insurance distributors integrate sustainability preferences into their suitability tests when offering advice to investors and that the products offered meet their clients' needs.

While Canada and the US have not yet followed the lead of Europe in pursuing explicit policy guidance, asset managers operating across all of these jurisdictions are beginning to align disclosure and increase transparency with the more stringent proposals of European regulators.

Regardless of jurisdiction, asset managers can clearly articulate the goal of their investment approach within the context of the broader sustainable investing spectrum and further work to educate investors to ensure a clear understanding of the vast differences between each approach and its intended outcome. Initiatives, such as those underway by European regulators, are major steps forward to providing the framework for greater understanding and standardization within the now well-established sustainable investing landscape.

[4] http://europa.eu/rapid/press-release_MEMO-18-3730_en.htm

For more information, visit AGF.com

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