Responsible Investing

Creating a Sustainable Advantage For Your Practice

Responsible investing (RI) has been among the most talked about and exciting concepts at the forefront of the investing industry this year. And with good reason. Evidence continues to pile up supporting the positive link between companies' records on addressing ESG issues, and positive shareholder return.

Clients are showing an increasing interest in RI also. This represents an opportunity for Advisors to gain first-mover advantage to position themselves as subject matter experts in this burgeoning area, while also differentiating their offering.

To encourage and facilitate Advisor engagement with clients, this report outlines 1) the **benefits to Advisors** of considering RI concepts and products, 2) **best practices for Advisors** to keep in mind, and 3) evidence supporting **the connection between investing responsibly and investment performance.**

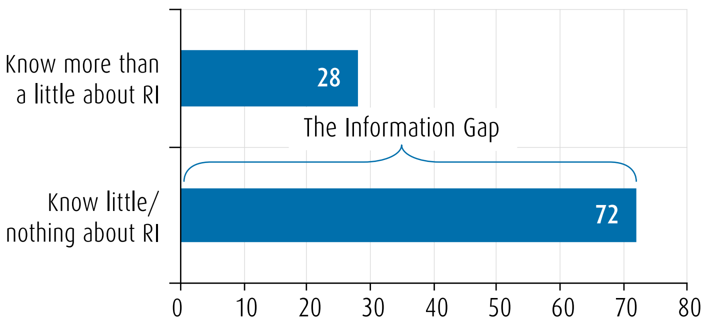
The Benefits of Responsible Investing for Your Practice

Build a higher quality portfolio: Companies with strong ESG characteristics often tend to be higher quality companies – they are better managed with superior risk controls, which can enhance portfolio risk-adjusted returns

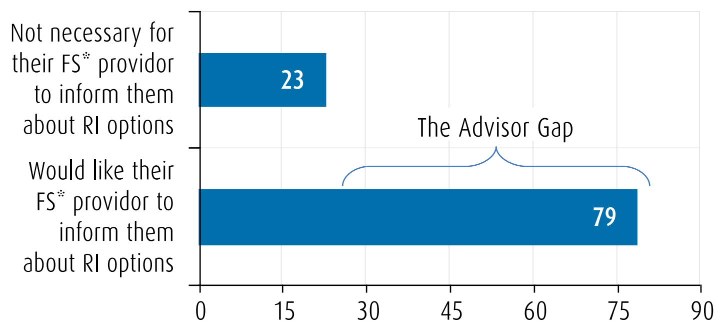
Aligning clients investments with their sustainability preferences: Recent research shows that in Canada, 79% of retail investors would like to be proactively informed about RI options from their financial services providor (which includes their Investment Advisor), yet only 23% have ever been asked if RI products interest them and only 28% deem themselves 'knowledgeable' on RI (Exhibit 1). This "information gap" represents low-hanging fruit for Advisors.

Exhibit 1:[1]

How much do clients know about Responsible Investments?



Do Clients want to hear about RI from their Financial Rep?



*FS = financial services

Be ahead of the curve of future regulations: One of the recommendations from 2019's widely-cited *Expert Panel on Sustainable Finance* suggested stronger, more formal responsibilities on Investment Advisors in engaging their clients on sustainable investment options. Although the uptake and timing of such regulation is not yet known, advisory practices that have already gotten ahead of the directional trend in regulation will be better positioned in the medium to long-term.

Fiduciary duties: A further output of the Expert Panel was the suggestion that climate and ESG-related considerations form part of an Advisors' fiduciary duties. That requires a broader interpretation of the concept of fiduciary duty, but it certainly limits a fiduciaries' exposure to legal liabilities than taking a strictly narrow interpretation of this concept.

Wealth Transfer: Millennials are a large and important segment - in the U.S., this segment is in the middle of receiving a $30 trillion transfer of wealth from their baby boomer parents. Its a similar story in Canada, and Advisors need to be fluent on sustainable investing themes and investments, as 90% of this demographic has indicated that they want to direct their portfolios to responsible investments over the next 5 years.

Exhibit 2:

What is the Expert Panel on Sustainable Finance?

The Federal Government created the Expert Panel on Sustainable Finance to investigate ways the financial sector can help encourage and direct money flows to support low-carbon Canadian initiatives.

Their final report contained 15 recommendations. Below are those most relevant to the Advisor Community:

- **Recommendation 2:** Provide Canadians the opportunity and incentive to connect their savings to climate objectives.
- **Recommendation 6:** Clarify the scope of fiduciary duty in the context of climate change
- **Recommendation 10:** Promote sustainable investment as 'business as usual' within Canada's asset management community.
- The Full Report can be accessed here

Things to look out for when building responsible-themed portfolios

Is performance being sacrificed? Responsible investing should not be an exchange of "values for value". Sustainability and performance should go hand in hand. Much like with a traditional investment fund, monitor and scrutinize performance and risk-statistics and investigate if a specific ESG mandate lags its particular benchmark.

Sourcing Ratings: There are a plethora of ratings providers out there – from MSCI to Morningstar, and increasingly a number of smaller providers challenging the incumbents. Assigned ratings can vary widely for the same security, and given the subjective, qualitative aspect of ESG ratings, advisors buying individual securities might find it beneficial to verify a particular company's rating against more than one provider.

Manager's approach to voting: Proxy voting is one of the most powerful tools an ESG manager has to promote sustainability issues in investee companies. Advisors should question fund managers about how they use their proxy votes and the progress being made on specific initiatives voted on – this can also help in having engaged conversations with clients.

Understand the holdings: Clients with specific restrictions may be more appropriate for Mutual Funds/ETF's which take an exclusionary approach, such as non-fossil fuel free or non-tobacco solutions. Others still might have a strong interest in a particular responsible idea or theme, such as gender diversity or water efficiency. It is important to understand what securities an RI fund holds; many of the solutions which score the best ESG ratings may still hold some of the traditional 'sin' stocks on the basis they are ESG leaders in their sector, for example. To this end, Advisors should understand the spectrum of responsible investment solutions (Exhibit 3).

Avoid isolating E, at the expense of S and G: There is a possible risk to over focus on one aspect of the ESG acronym to the detriment of the others – for instance, an airline company using alternative energy sources may have a problem with governance regarding excess executive compensation. A real life example of this occurred in 2018 with the U.S. utility company PG&E, which was lauded for its clean-tech investments but ultimately filed for bankruptcy after governance failures. Giving due attention to each of the three inputs can help mitigate against this.

Exhibit 3:

The spectrum of responible investing

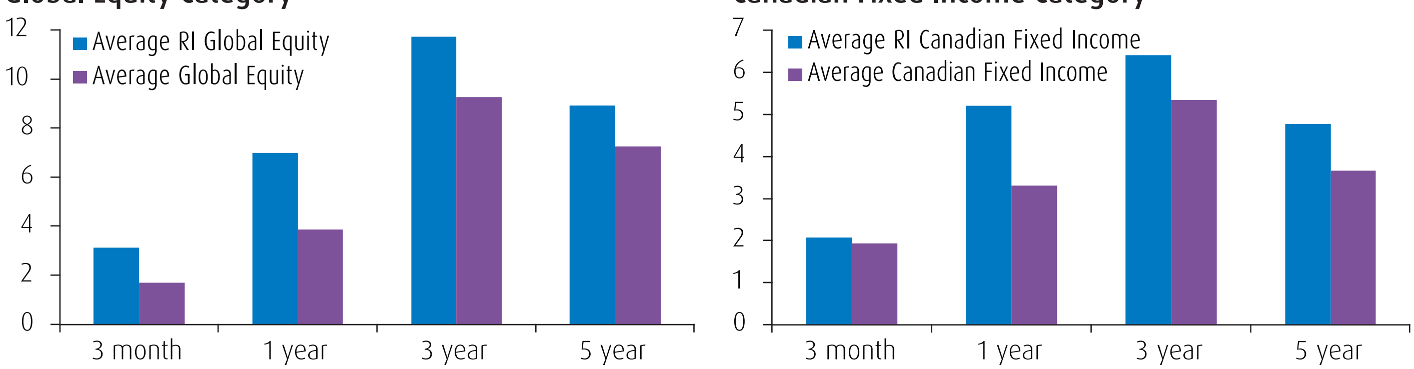
How Have Sustainable Investments Performed?

Perhaps the biggest hurdle facing advisors is the fear that responsible investing strategies can detract from performance – leaving returns on the table at the expense of sustainable-related principles. As alluded to above, the opposite is in fact true.

Data from Canada's Responsible Investment Association (RIA) shows that almost 75% of responsibly managed funds domiciled in Canada outperformed their Category averages over a 1-year period, with similarly high (above 50%) proportions over longer 3 and 5 year periods. Therefore, the myth that investing responsibly and delivering outperformance are mutually exclusive can be dispelled.

Exhibit 4:[2] performance of RI Funds in Canada, as at June 30th 2019

Global Equity Category **Canadian Fixed Income Category**



Empirically, there have been many studies which support the link between ESG and risk-adjusted performance. Among the most cited, the University of Cambridge Institute for Sustainable Leadership noted that negative ESG factors can be associated with higher volatility and/or cost of capital. BMO Asset Management produced the following document which goes into more depth on some of these studies. LINK

The global growth of RI assets

There has been exponential growth in RI globally.[3] European investors have led the way as early adopters, with pension and institutional investors, as well as regulatory necessities, acting as drivers. **Canada and the U.S. are still developing RI markets – unlike in Europe, the growth here has been more market driven than regulatory driven – however with the prospect of more regulation on the horizon, Canada is poised for further growth.** In particular, issues ranging from concerns about the use of plastics, to increasing awareness that Canada is warming at a faster clip than the rest of the developed world, are pushing RI closer to the forefront of investor concerns.

Exhibit 5:[3] the growth of RI globally

	2014	2016	2018	Growth Per Period: Growth 2014–2016	Growth Per Period: Growth 2016–2018	Compound Annual Growth Rate (CAGR) 2014–2018
Europe	€ 9,885	€ 11,045	€ 12,306	12%	11%	6%
United States	$ 6,572	$ 8,723	$ 11,995	33%	38%	16%
Canada (in CAD)	$ 1,011	$ 1,505	$ 2,132	49%	42%	21%
Australia/New Zealand (in AUD)	$ 203	$ 707	$ 1,033	248%	46%	50%
Japan	¥ 840	¥57,056	¥231,952	6692%	307%	308%

Note: Asset values are expressed in billions.

Retail investors increasingly want to be a part of the movement powering positive, meaningful change – what they are lacking is guidance and direction in how their portfolio can help fulfill that desire and make a difference, while maintaining healthy risk adjusted returns. Against this backdrop, an excellent opportunity presents itself for Advisors to differentiate their services through partnering with clients in investing responsibly

BMO Global Asset Management

[1] Source: 2019 RIA Investor Opinion Survey
[2] Source: RIA Canada Q2 Funds Highlights – July 2019
[3] Source – 2018 Global Sustainable Investment Review, by the Global Sustainable Investment Alliance.