Responsible Investing

Worth Allaye-Chan Investment Counsel has provided investment services to institutions for more than 20 years. Our clients get the best of both worlds – truly independent investment management thinking coupled with advisory skills honed through decades of client care.

We keep our client list small, select, focused on those who can benefit most from our approach, and we invest our own money right alongside theirs.

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Whenever Responsible Investing is the topic of conversation, strong values and fixed viewpoints seem to spur good debate. After 20 + years of offering clients responsible investment portfolio strategies, we have learned to respectfully discount some of the extreme views and to ensure our focus is on the objective and the responsibilities that go with it. For individuals and family investments, it's simple. Make an informed decision based on your values and accept the consequences. When a fiduciary responsibility is involved, however, it is a bit more complex and there are some general dos, don'ts and guidelines you can follow. That said, even amongst proponents of responsible investing there are different opinions. Here we try to clarify much of the misconception and address some of the realities to assist fiduciaries understand responsible investing and make prudent decisions. Necessarily, we are just going to scratch the surface of how responsible investing is carried out.

As fiduciaries, you will likely receive input from your community members. Perhaps that might be: "we don't want to have our money in that company!"; or "we don't want to invest in any company that's involved in that type of activity"; or even, "we would like to know that the companies we are invested in are behaving in the best possible manner from a social, environmental and governance perspective." The media offers a constant stream of articles revealing poor behaviour by undesirable corporate citizens, but what is the overall reality of a company's activities? It's perhaps unrealistic to expect any company to perfectly satisfy all investors, or even all of your members. Is a poor track record of environmental or even sales behaviour enough to disqualify a company from investment or should their recent efforts to improve be lauded and supported? There has to be a way to get better information beyond the latest condemnation in a newspaper.

Many investors applaud Elon Musk's progress towards replacing fossil fuel burning cars with much cleaner electric vehicles. Others, however, question Tesla's corporate governance for allowing the firm to complete a $2.6 billion bail-out of Musk's ailing Solar City and claim that any future synergy benefits are at the expense of the then current Tesla shareholders.

Following the 2010 Deepwater Horizon oil spill fiasco (now a popular movie), BP made valiant efforts to relabel itself as *Beyond Petroleum*, committing to invest in other, renewable forms of energy. Follow on claims and commitments were made by other oil companies such as Shell, Total and Statoil. Critics claimed these were largely public relations strategies rather than good business ventures. The U.S. giant oil company Exxon, and others decided not to follow but to stick to their knitting, oil! Are they to be criticised for not committing to renewable energy or lauded for knowing their business and sticking to it through good corporate governance?

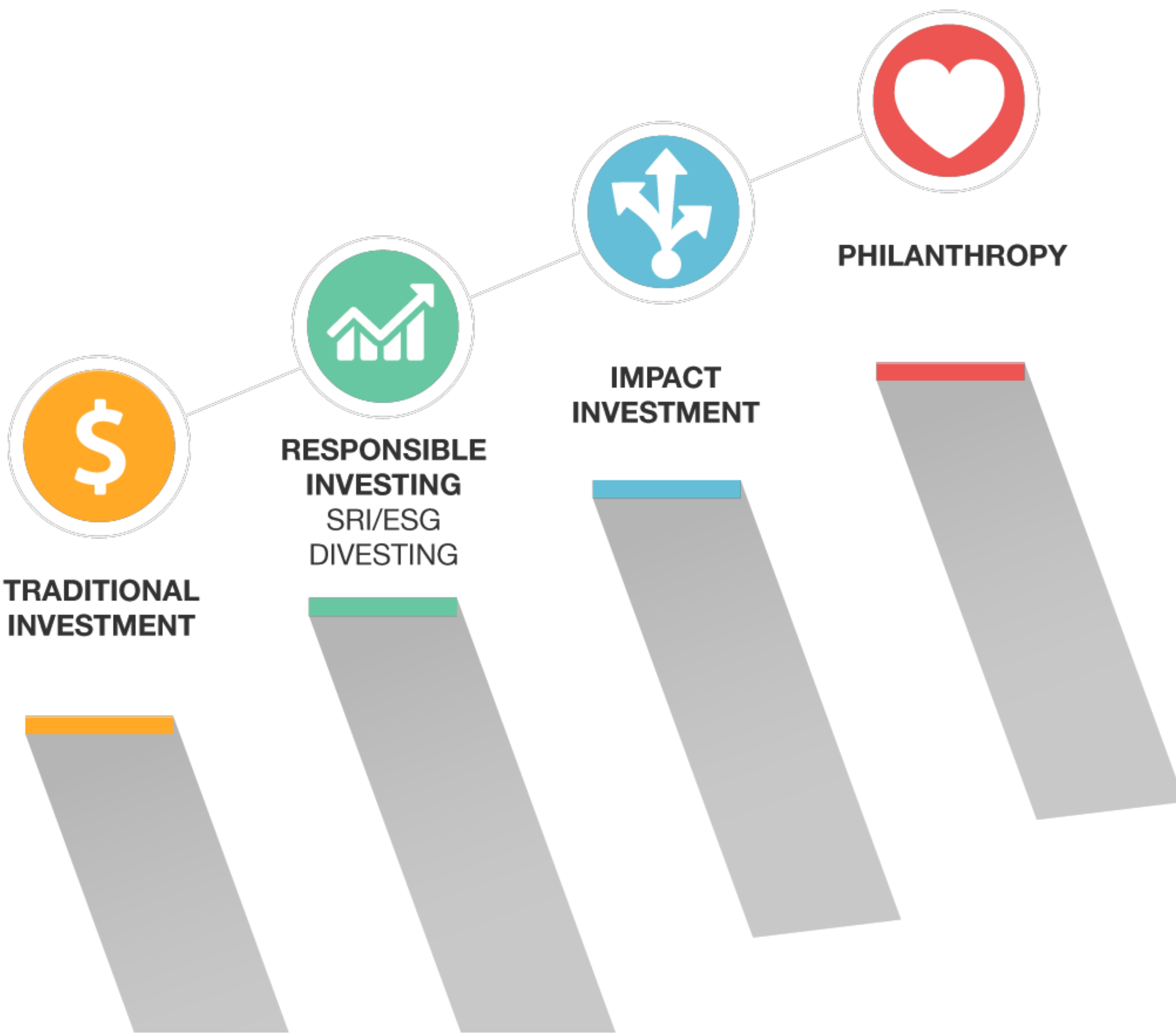
Nestle was criticized for its sourcing of palm oil from suppliers engaged in labour abuses, and separately for sale of water drawn from community supplies. Yet the company ranks very well in overall assessments such as Fortune's 2016 Change the World list, FTSE4Good measurement, the Access to Nutrition Index (ATNI), and the Dow Jones Sustainability Index.

Valeant Pharmaceuticals and Volkswagen have had well publicized troubles clearly arising out of poor governance structures, and remain rebuffed by market forces.

As a fiduciary, how do you avoid investment in businesses with poor social (employee, customer and community) behaviour, poor environmental track records, and ineffective governance structures and decisions? It's all a bit overwhelming, and getting to a balanced assessment on just one company, let alone a whole portfolio, seems a monumental hurdle.

Even if you could confidently focus on electric and other renewable energy business, on non-resource technology businesses, on solar panel manufacturers, would that produce a diversified portfolio of companies and a competitive return expectation that would satisfy your fiduciary duties? Probably not. For now, and likely for a long time to come, there is no measuring stick which equates the social benefits of good corporate citizenship with financial metrics. What you really need would seem to be a reliable, repeatable investment methodology that has enough track record to give you the comfort of a competitive return (relative to your benchmark) AND a disciplined, repeatable and balanced assessment of each business's corporate citizenship. The practice of responsible investing attempts to do just that.

"Responsible Investing" has been around for decades and the methodology has progressed far enough to satisfy most of these needs. The terms ethical investing, socially responsible investing (SRI), and environmental social governance (ESG) have all been topical and, here, we will use them interchangeably. Today, well intentioned investors are trending towards Divesting (excluding all fossil fuel content, in particular) and Impact Investing. Here's how each falls into the overall spectrum of allocating funds in concert with good intentions.



With Traditional Investing, funds are invested with the full intention of making a competitive financial return and managing risk. It's all about the money! At the other end of the spectrum, Philanthropy is putting your money where your heart is without the expectation of any financial reward or repayment. Impact Investing is the allocation of funds with the intention of making a return on the money, but likely not a competitive return. The positive social benefit from Impact Investing has a bigger influence on the decision than any financial expectation.

Responsible investing falls somewhere in the middle of the spectrum. It seeks to provide a competitive return expectation and offer an opportunity to EXCLUDE clearly unwanted companies and corporate activities.

You have choices. There may be a company with which the community has a poor relationship and it's easy to exclude one or even a few companies without material impact on longer term performance. It's even possible to exclude certain business activities. Nuclear power and military and weapons contracting are common targets. Some investors exclude sale and manufacturing of alcohol and tobacco products; others pornography and gambling. You have choices allowing you to instruct the investment manager to EXCLUDE unwanted companies and/or business activities. These types of exclusions may be all you want or need and you can stop at that point.

If, however, you wish to go further, you can direct the investment manager to use a disciplined filter or screen to INCLUDE the best ranked of the remaining businesses over those that score the worst. This is usually referred to as "best of sector" ranking. It's a ranking of companies relative to their peers operating in the same industry, more so than an absolute endorsement.

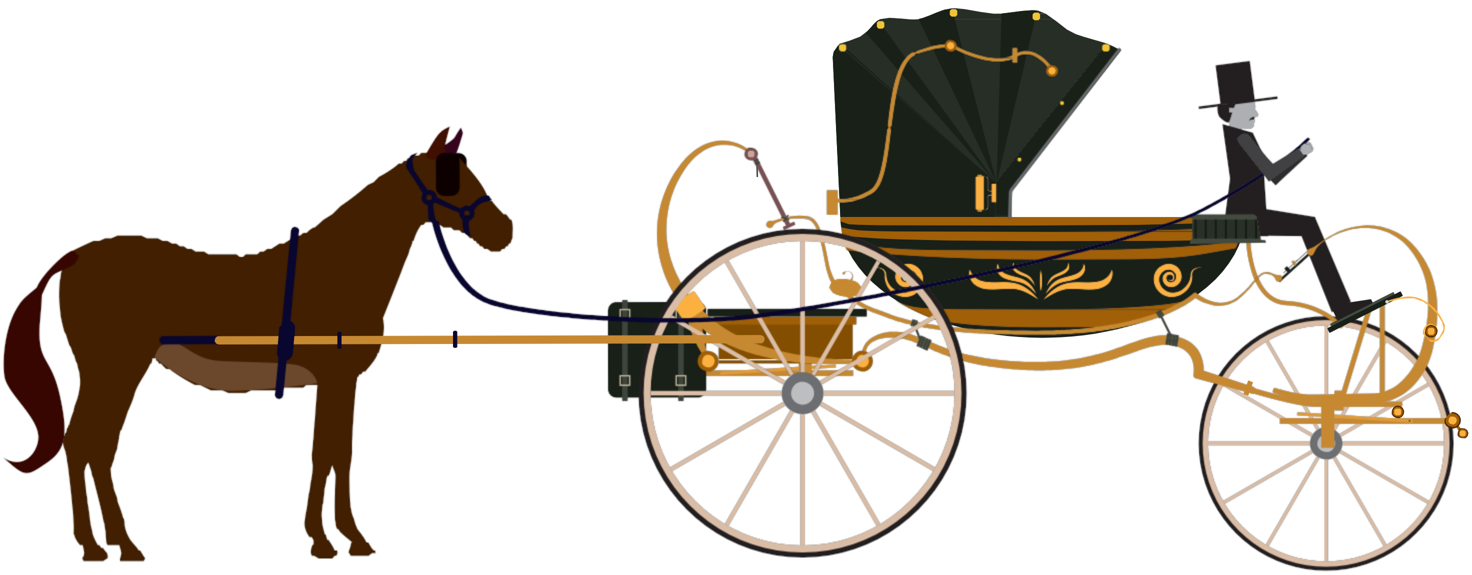
The resulting portfolio contains none of the undesired (filtered out) business activities and, for the rest, favours the better scoring businesses (when measured against their peers). It is important to note that in a "segregated portfolio" (where your Trust or Nation is the only investor), you have all the choices to customize the responsible investment parameters. If, however, you are invested in an existing responsible investment pooled portfolio or fund, you do not have any say in the predetermined investment and responsible investment methodology.

Although the application of responsible investment practices may differ from manager to manager, the exclusion of undesired companies and business activity, followed by "best of sector" choices is the most common methodology used, and has a performance track record of returns competitive with those of the relevant benchmark indices.

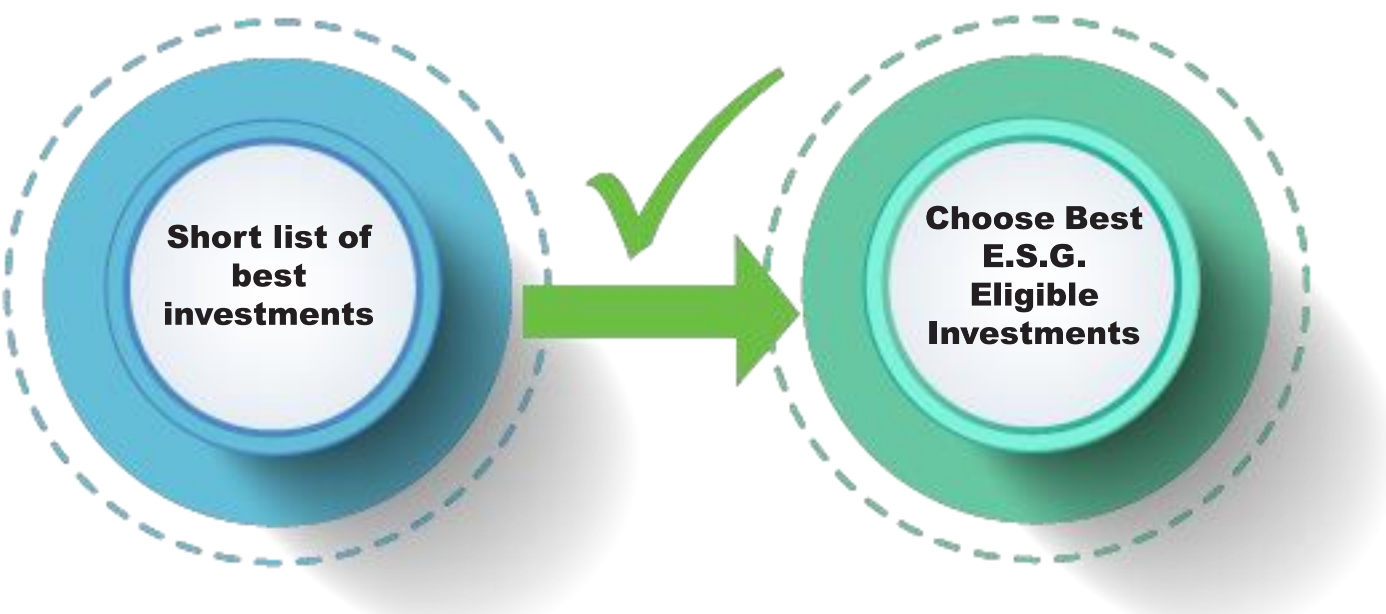
Excluding one or a few companies from the universe representing your benchmark has little, if any, impact on investment performance over time. Removing an entire and significant sector, however, will have an impact on performance. Divesting involves the exclusion of a more significant sector of the marketplace. Topical today, fossil fuel divestiture is essentially removing investment in the energy sector. In Canada, the sector is 22% of the entire S&P/TSX (only about 7% of the S&P 500 in the U.S.), and avoiding any large sector of the economy will lead to some periods of underperformance. Proponents of fossil fuel divesture point out that this divesting has not caused underperformance over the last 3 - 5 years. However, in a note of caution, the last 3 - 5 years were periods of significant underperformance by the energy sector and, consequently, removing the sector was an advantage. For most of the period since the turn of the century, however, energy sectors in Canada and the U.S. have significantly outperformed the benchmarks. In the future, we anticipate periods where the energy sector will once again outperform, raising the question of underperformance by portfolios that exclude fossil fuel businesses. Rather than exclude the entire sector, we prefer using "best of sector" SRI/ESG filters to favour specific companies which have the best track records on social, environmental and governance issues, and avoid the worst.

We also note that active portfolio management in responsible investing may lead to greater variance from index returns. Even so, fiduciaries, such as a board of trustees, can gain comfort from the fact that responsible investing has not been shown to materially underperform comparable traditional investing approaches over time.

It is important to note that "best of sector" screening gives the investment manager choices of better scoring companies and that the very best may not necessarily be the best investment. This adds a degree of variance in the outcome for one manager versus another.



In the end this is still ***investing*** and it is important not to put the cart before the horse by choosing a list of best SRI/ESG scoring businesses and then looking to see if they are good investments. The result might be a "Goody Two Shoes" list of well-behaved corporations, but poor investments. Rather the manager might have a short list of the best financial investments (after any exclusion as directed by the investor), and then apply an SRI/ESG filter to find eligible investments from that list.



How do you get started? Perhaps a good place to start is to ask the following questions of your investment manager: Do you offer responsible investment portfolios? How long have you been doing it? Is there a cost difference? Who does the SRI/ ESG assessment/screening? How is it applied? What is the likely impact on performance?

For you, the investor, there are choices and decisions to make. What company(s), if any, do you want to exclude? What business activities do you want to exclude? Do you want the investment manager to apply an SRI/ESG filter to sort the best from the list of remaining companies? Once made, these choices can simply be added to your Investment Policy Statement, perhaps as an Appendix for easy review and updating.

Some investors prefer to actually hold shares in a business that engages in activity they do not like. These shares can be held in a separate account, registered and voted. You can also make your viewpoint known to the company by gaining a voice at shareholder meetings either directly or through an independent shareholder activism agent.

The world of responsible investing need not be a daunting unknown, and if you have an interest in learning more, please contact us at Worth Allaye-Chan / Raymond James: 1 855 659-8066.