TD Asset Management's Roundtable on Sustainable Investing

In today's investment environment, historic rules of thumb are being questioned. Appropriate investment strategies now must include determining fiduciary responsibilities and having a clear understanding of the drivers of risk and return. This means more focus is being placed on sustainable investing.

To look into the state of sustainable investing today, TD Asset Management and *Benefits and Pensions Monitor* brought together James Gifford – executive director for the UN Principles for Responsible Investment Initiative (UNPRI); Susan Enefer – manager of shareholder engagement as a member of the equity investment department for BC Investment Management Corporation (bcIMC); Kelly Gauthier – a member of Mercer's responsible investment team; Thomas George – co-manager of TD Asset Management's Global Sustainability Fund; and Maxime Zehrt – sustainability analyst at TD Asset Management.

Joe Hornyak, executive editor for *Benefits and Pensions Monitor*, is the moderator.

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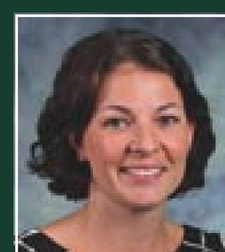

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Moderator: What is environmental social governance (ESG) investing and how is it different from SRI and the ethical investing that preceded it?

Maxime Zehrt: The first generation of responsible investing was geared towards more ethical-type values. It is still ongoing and will continue to be in demand by those looking to invest with a principle-based approach. Traditionally, it was seen as the only way to invest responsibly. This type of investing was achieved by removing certain sectors or companies altogether, particularly the sin stocks – alcohol and tobacco for example.

This evolved into socially responsible investing where investors began integrating ESG factors more formally. It still involved some type of exclusionary screens by removing certain sectors, such as those deemed damaging to the environment or where there were concerns about social issues.

This, the third generation, is where we are currently seeing a lot of traction in the mainstreaming of responsible investing. Rather than looking at ESG in isolation and using negative screens, we are working towards integrating it in our investment process. Ultimately, we are interested in those ESG factors that assist us in identifying and quantifying new risks and opportunities that financial indicators alone are not able to capture.

Susan Enefer: *At BC Investment Management Corporation, the evolution of responsible investing is apparent in the fact that we, as a mainstream investor, until a few years ago only understood SRI investing to mean exclusion.*

Over the last five years, we have done further research and re-examination of that. We understand that an SRI strategy does not have to deal with exclusions. It can actually be more inclusive. That has been a very significant shift in the thinking that we have undertaken. It is from exclusion to the understanding that you can be an SRI or ESG practitioner with an inclusive policy.

James Gifford: The active ownership side is also a really important development.

Twenty years ago, active ownership was seen as an activist model or a very traditional ownership governance model. This, in some ways, has matured and now we are seeing shareholder engagement.

The role of responsible investors is encouraging companies to aspire to be world-class companies. This is an important part of this whole space, yet people tend to focus on the investment side. Just as important is the ownership side and what they do with the investment once they own it.

Thomas George: *That evolution beyond exclusionary screens has been the key differentiator between traditional SRI and sustainable investing, allowing strategies to move from a niche to mainstream. By including all sectors we can truly seek best-in-class companies and it enables benchmarking within each industry group. Further to James' point about active ownership and engagement, benchmarking helps establish best practices for companies that aspire to be world class.*

Moderator: What are some of the other factors that have helped us move from ethical screens to ESG and sustainable investing?

Kelly Gauthier: More recently, there has been a lot of resistance to screening. Many of the mainstream players are fundamentally opposed to a constrained universe.

Once the methodologies evolved to best-in-class, to ESG integration as a whole, to being able to recognize that these extra financial criteria were not so much extra financial, but additional risk factors, then it was able to become much more of a mainstream play.

When you layer on top of that the active ownership side and pair it with everyday societal trends, ESG became more mainstream, less activist. It was what is in the newspaper everyday, what people are doing in their homes, in their lives. Those two pieces together provided momentum for this movement, bringing it on to a mainstream platform as opposed to a specialist platform.

Zehrt: *A factor on the environmental side that has garnered the attention of both mainstream and SRI analysts was the introduction of a cap-and-trade in Europe along with a price on carbon. It's a great example of an environmental factor that has really pushed internalizing a historical external cost for companies. This has led companies to think more deeply about efficiency and how environmental costs can flow through to the bottom line, either positively or negatively.*

Gifford: The financial crisis actually raised awareness of the broader responsible investment movement as well. It has shaken the faith in the so-called 'geniuses' of Wall Street who have been telling us for decades that they are all about maximization of profit – they are good fiduciaries and they are looking after your money.

What was demonstrated is just what a facade a lot of the practices that were being undertaken were in terms of protecting the long-term interest and financial security of beneficiaries.

It goes beyond carbon, it includes corporate governance and monitoring and reporting of all of your impacts. That is the type of company and the type of behaviour that will deliver long-term, stable, secure returns for beneficiaries rather than the behaviours that led to the crisis a couple of years ago.

George: *That's exactly it. It's about rewarding companies that are taking the long view and exposing the facades that lead to crises, be they financial or even environmental such as the Gulf of Mexico oil spill. ESG analysis presents a framework to address risk factors that are outside the scope of financial statements today.*

Enefer: It is somewhat disheartening from the investor point of view that we continue to lose economic value from poor ESG performance and ethical lapses. Why don't companies see benefits rather than burdens here? I wish I could point to more success stories and examples where we see alpha being added by forward-looking companies with good ESG practices. Instead, the responses to value-eroding issues like weak shareholder rights, poor labour practices, or climate change are usually developed from a crisis or from regulation that makes ESG performance a compliance exercise.

For right now, we are considering ESG in terms of the risk management element and how we assess management quality and the ethics and integrity with which they conduct their business.

George: *Risk management is definitely one of the clearest applications of ESG analysis. With respect to alpha generation, a clean technology strategy is one way to potentially capture ESG alpha. It provides direct exposure to the enablers of the long-term environmental sustainability – clean water, efficiency, and alternative energy.*

Gauthier: Mercer has produced two reports looking at the actual financial impact of investing in ESG. There were 36 studies included and only three of them found negative correlations to RI or ESG investing. Twenty were positive and the remaining were neutral. The evidence is there. It is just taking time to make its way to the fore.

Zehrt: *Like other investment strategies, there is a range of responsible investment products to choose from. Sustainable investing is, however, not a magic bullet. ESG, in isolation, may not lead to outperformance. However, in combination with good industry characteristics and strong fundamentals, those companies which focus on the sustainability of their firm will likely be in a better position to uncover new trends and be able to manage risks more effectively given their broader view of their company.*

Gifford: It is also important from the systemic side. Now, that might not be that relevant for an active manager with 50 stocks. But, if you have hundreds of thousands of stocks, then you are highly diversified and externality is being generated by one company and imposed on a catchment or an ecosystem or an atmosphere that is actually causing damage to thousands of other companies, leading to sub-optimal economic outcomes.

This is a really important issue for larger diversified investors and many of the clients of even smaller active fund managers. Environmental externalities lead to sub-optimal economic outcomes overall. These investors have, in effect, a slice of the global productive capital of the economy and they are being damaged by the results of these externalities. That is what they call the universal owner hypothesis.

Moderator: So how do you go about incorporating ESG practices and how do they add value?

Gauthier: *We work with clients that are working on integrating ESG and taking their first steps which might, at the board level, mean dealing with policies and starting to wrap their heads around all this terminology.*

Then, usually with our clients, the next step is something like getting involved with the UNPRI, looking at collaborations where they can start to learn about the space and where they can find other investors that have similar values that are trying to achieve similar goals.

Then, they are going to look at how they actually integrate ESG into their portfolios and what does that entail because that is a much larger undertaking, both philosophically and from a resource standpoint, for most asset owners.

Zehrt: One of the ways we look to incorporate ESG is through an internally-developed sustainability matrix, which uses a combination of factors across all ESG pillars. Together, these form the basis on how we assess a company's management of its ESG capital. We provide these scores internally as an additional factor to consider and a way to stimulate conversation surrounding the company's quality of management.

Through this analysis, we seek to uncover trends in the data, enabling us to better understand the additional risks companies may be exposed to. Opportunities may also come to the surface with the increasing understanding of longer-term structural ESG trends.

Moderator: Are metrics enough to determine a company's sustainability?

George: *The BP disaster fits very well here. The company was ranked best-in-class by many socially responsible funds and indices such as FTSE4Good and the Dow Jones Sustainability Index. The disaster really highlights some aspects of what the ESG industry is actually rewarding right now, which is the transparency and data found in glossy reports.*

Currently, it is difficult to compare BP versus peers on a like-for-like operational basis, but we know BP reported a lot more data, so they got a few more points.

To me, there are a lot of lessons learned, positive and negative, but it is a controversy that could bring our industry forward. This is where ESG analysis can add real value.

Gauthier: One of the things that rang home to us about BP was that it reinforces the fact that best-in-class is one approach, but there are still some fundamental sector qualities that are not to be overlooked. Most of its reporting has been favourable, sector comparable, but in some areas we need to remember that it is still a massive oil producer and there is an inherent environmental risk there, as well as safety and community issues. This situation has brought that home, that we still need to consider what sectors we are investing in – and to what degree – and what risks that represents to your portfolio.

Gifford: *Another key point with the BP disaster is a lot of the safety issues were a result of regulatory failure. Whether it be political donations or giving the executives of the regulator free holidays in Aspen, these are exactly the types of things that responsible investors would be horrified about had they delved deeply into it. Part of it is really getting to the bottom of what is poor corporate conduct that leads to the cutting of corners and short-term-ism. That is exactly what happened with BP.*

Moderator: So are responsible investors considering if where they are investing their money is properly regulated?

Gifford: There are a whole lot of dimensions. One of them is obviously the basic due diligence in terms of ensuring you have considered the full gamut of risks. Another is active ownership, ensuring that management acts in the best interest of shareholders over the long term.

Then, there is the systemic side. Investors have a responsibility, just as all active in society do, to ensure that the system actually functions. What we saw in the regulation around oil drilling and in the regulation around financial markets was a failure of regulation leading to serious losses and financial damage.

Investors have a collective responsibility to at least play some part through industry associations or through the UNPRI and other global initiatives to really try to push good practice in these areas.

Enefer: *I am going to play devil's advocate here and give you an illustration of where bcIMC tried for a decade, if not more, to make change at a macro level. We recently reduced our investment exposure to the Japanese market because we found there just did not seem to be an appetite or a willingness to bring fair and reasonable governance practices into its public equity market.*

We have choices in where we place our capital and our capital will be placed in markets that welcome it and that value it. That decision about Japan was very much a difficult one to make, but it was largely based on governance concerns. We try very hard to make change, but there has to be a point where we say we are going to move on.

Moderator: Where is Canada in terms of ESG and sustainable investing?

Gauthier: Canada itself is dominated by a lot of bigger funds and then there is a smaller base of foundation and endowment funds so the market is a little fractured.

With respect to globally comparing Canada, we have seen that Canada has been moving at a nice, slow, steady pace. We would say that the Canadian market is probably on par with the U.S. market today in terms of integrating these concepts, across a majority of the largest public funds. However, we are not quite where Australia and the UK are, although we have been making good progress.

From what we know of the funds in Canada, most of the big funds in Canada are tackling this in one way or another. Everybody is aware of it. Everybody is trying to figure out their own solution to it, but everybody is more or less on board, which is what we want to see in terms of the development of the market as a whole.

Moderator: What about the uptake globally?

Gifford: *We are just analyzing this year's UNPRI survey and the increase in momentum is really unmistakable. There is just no doubt that this movement is going really strongly and just the self-reporting of our signatories of what they are doing from year to year is consistently increasing.*

Just to give you an example of the number of signatories that are reporting now, we have almost double the number from last year and more than 400 of our signatories participated in the survey. Around 200 of them are publishing their results, also their responses, online, which is probably one of the biggest increases in investor transparency we have ever seen. Across the board, it is really fair to be quite bullish and optimistic about the momentum of this space.

Moderator: What sort of strategies are asset managers using in terms of implementing ESG?

Enefer: bcIMC is trying everything. We have a U.S. equity portfolio which applies negative and positive ESG screens in its company selection process. We have an engagement strategy for our overall global public equity portfolio. We have an environmental risk management strategy that applies to our real estate holdings. We plug into coalitions that consist of investors from around the world and we combine forces to make change in the market, in the companies, and even in the instruments in which we invest.

Responsible investment is a key component of our mission statement and our board-approved strategic plan, specific activities are mapped out annually in our operational plans on a per-department basis and they are acknowledged in our employee compensation program. People are being rewarded for the work that they do here on ESG which breathes a lot of life into our overall integration.

Gauthier: *With the breadth of this subject area, a lot of asset owners and managers find themselves a little overwhelmed by what to focus on, they cannot wrap their head around everything and engage on everything. One of the approaches that seems to be taking shape a lot more is issue-specific – picking two or three issues that really align with the organization's mission or goals and focusing on those. That gives them, once they have disclosed that, an excellent position to be able to defend themselves by saying 'we are focusing on these issues, this is what we are going to surround ourselves with and we are really going to dive deep on these issues and, for now, we are going to leave everything else out of scope.'*

Moderator: What sort of strategies are we seeing investment managers bringing to the table?

George: In terms of dedicated offerings, we have seen many sustainability and socially responsible focused funds launched at the retail level over the last several years. Dedicated clean technology funds have also been an area of strong growth over the last decade. Overall, the growth of these varying strategies has been driven by the underlying demand of investors.

With respect to integrating ESG analysis into traditional investment mandates, we're at the point right now where education is paramount. We're trying to help portfolio managers understand the ESG outliers – who those leaders and laggards are across each pillar – it helps start the dialogue, and ultimately isolating those outliers should provide better risk-adjusted returns.

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Zehrt: *Beyond our ESG matrix, which helps identify those outliers Thomas mentioned, we are also cognizant that being a responsible investor demands active ownership. Building upon our history of promoting good governance and actively voting our proxies, we have set up formal committees to tackle engagement issues.*

We also feel our chances for success are higher when we partner with other institutional investors. As an example, the Carbon Disclosure Project we take part in allows us to seek pertinent information from companies with the collaboration of other investors. In order to truly push the dial forward on sustainability within the industry, so-called collaborative competition needs to occur.

Moderator: Are there examples where using ESG principles have steered investors away from an investment?

George: In a global context, regulatory risk is a key area where ESG principles help steer investors away from higher risk investments. The most concrete examples are found in the resource intensive sectors, with risk factors such as carbon or water management. The most efficient and innovative companies tend to be setting the regulatory agenda, anticipating rather than reacting.

Zehrt: *Similar to fundamental analysis, which doesn't depend strictly on financial ratios to drive a decision, we do not view ESG in isolation rather as an additional factor to consider in the investment process. All other characteristics that a prudent manager reviews need to be in place in order to drive a buy or sell decision. That said, all else being equal, ESG factors are increasingly becoming more important for those companies that are leaders amongst their peers and these companies will need to manage their ESG capital effectively in order to maintain leadership.*

Moderator: What will sustainable investing look like in the future?

Gauthier: Our goal is that we are working ourselves out of a job – that ESG becomes a well-integrated concept, it becomes another risk factor that managers and companies are looking at on the list of every other risk factor that they currently consider.

We hope it becomes less of an externality, less of a specialty subject area, and that it is just a part of everyday business.

George: *Hopefully, when we look to the future, sustainability will be a fundamental part of the way the market values a company, enabled by the availability and standardization of ESG data. Management teams will be rewarded for both financial and sustainability achievements based on standardized metrics.*

Moderator: So what is keeping us back from being there or getting there faster?

Gauthier: I would say a few things.

One is information – the availability of data and the consistency of information. Secondly is mindset, as there are still questions around fiduciary duty, which, from our perspective, have been dealt with, but lots of boards do not feel that way.

To a certain degree, we see some of those obstacles as being generational. Attitudes are changing slowly over time as they do with everything else.

Zehrt: *We owe a lot of credit to the UNPRI for getting the message across and their success is evident with the ever-increasing membership.*

My long-term view is that being a differentiator in ESG analysis will be key. All investors will be looking at it but, ultimately, the question will be who is doing it most effectively. Those firms taking an active approach now will likely benefit over time.

In the interim, there is eventually going to be a tipping point, with more investors analyzing it than less. This may be a few years away; however, it should at least be on investors' radars.

Gifford: We are not quite at a tipping point as the real tipping point is when quite a few large asset owners put this into their RFPs and very strongly discriminate in favour of funds and investment managers that have this capability and do it well.

It is starting to happen. The French Fonds de Reserve incorporates responsible investment capability into its RFP process and it is unlikely that you would get a mainstream mandate from the FFR unless you have this going along nicely.

Once we get to the point where that is really the way things are, then we really have fully embedded it in the market.

Enefer: *On the smaller investor side, an issue of some concern is the notion that this is going to take a lot of resources. Yet, responsible investing is as simple as taking an active role in voting your shares. It is as simple as adopting a policy across your organization or across your fund and then asking for accountability towards it.*

Gauthier: Increasingly, from our view, ESG is on the table and it is coming from two perspectives.

One is there has been some organic growth in the industry. We are rating ESG products across the market. Even on searches where ESG has not come up in the conversation with a client, that information is being put in front of the client. So they start to see it from the back door and say 'oh, the ESG information is here, what does this mean and how do we use this.'

The other thing for small funds is collaboration. ESG organizations, for the most part, are so easy to join. They are easy to participate in. They do not take a lot of resources and it gives you such incredible leverage to be able to access and understand what is going on out there and get involved without a lot of resources. Until you get involved in it, you have no idea the power of what is available to you.

Moderator: With all the attention on China's environmental record, how does an under-funded pension plan rationalize ESG principles with the potential returns from investing there?

Zehrt: *Personally, I do not think they are mutually exclusive. Many large multi-national companies domiciled in developed countries see their growth coming from these emerging economies. Given their brands, they understand that managing ESG risks is paramount to protecting their reputation and demonstrate so by being leaders in sustainability reporting. Having these companies set the benchmark will no doubt increase the willingness of domestic companies to improve upon their own ESG practices.*

There are also many companies in emerging markets that have already taken an active approach to sustainability. China Mobile, for example, is the largest mobile telecommunications group in the world and it leads on sustainability among emerging market companies.

George: Further to that point, the long-term development goals of China should strategically align with environmental sustainability. They are net importers of natural resources so efficiency should be paramount, making the principles of sustainability a natural fit in emerging markets.

The governance and social aspects of sustainability are the clear areas which can be developed further. With multi-national companies, we can push for greater transparency and accountability in these regions.

Gifford: *Just in terms of the broader Chinese context in responsible investment, it is just a completely different environment from other places where funds tend to have more autonomy.*

There are huge opportunities in these markets and whether a pension fund is underfunded or not, they will be looking for good returns.

But, the ESG risks are also probably the most material that you could come across. When you have a pollution event in China, it is a big deal and the impact on companies is huge. If you have a governance problem with corruption or whatever it might be, these are really big material issues.

A lot of the risk in investing in companies in emerging markets is very much around environmental, social, and corporate governance risks so these factors are even more important.

George: That is completely right, especially in emerging markets where governance risk is critical.

When we are looking at investments in those regions, if there is even the slightest governance folly, it is just a no-go. Ultimately, for those companies that have had issues related to corruption or fraud, the market tends to severely punish any mistakes.

I would say the market impact, related to corporate governance issues in emerging market companies, is much greater in terms of magnitude and volatility compared to their developed market peers. In the absence of a mature regulatory environment, transparency and trust are paramount.

Moderator: Are people still going to stick to their principles or are they going to get caught up in the exuberance of returns if we see a sustained market rally?

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George: *If we ever do go back to anything resembling the roaring '90s, issues related to rapid urbanization and increased natural resource consumption will be critical. In an economic environment where oil and base metal prices are significantly higher than they are today, there will be real and tangible financial benefits of being more efficient. Ultimately, that will be a great driver of ESG.*

Additionally, clean technology becomes that much more important in a world with tight natural resource supplies.

The fundamental principles of sustainability are very aligned with a growing global economy.

Gauthier: I would like to think that the price of carbon and the carbon market is becoming mature enough that it is not going to disappear. Despite an economic recovery or even a boom, the carbon market is still there and there are opportunities in the carbon market. There are opportunities for companies to gain efficiency and there are opportunities for financial markets to make money on the carbon markets. Those opportunities are well enough in place. They are not just going to vanish.

Enefer: *I cannot speak for the industry, but I know at this point in bcIMC's evolution, we certainly would never go to a profit-at-any-cost mentality. The ideas of prosperity and equity and considering as many risks as possible, financial and extra-financial, meets our mandate to deploy all reasonable means to keep our clients' capital protected and their interests served. I believe that encouraging good ESG performance in the companies and markets in which we invest will always be a reasoned and reasonable strategy for bcIMC.*

Gifford: I cannot see this slowing down at all as there will always be cycles. Really the question – from each cycle, from each boom and bust, to the next one – is do we learn something. If this keeps going at the pace it is going, and we have to be realistic, we still have a long way to go, if we do have this type of activity really become mainstream, the next boom will be slightly less severe perhaps or certainly the companies will be watched much more carefully than perhaps in previous times.

Moderator: What are the key takeaways from today's discussion?

George: *On a positive note, it is great to hear that there are so many sponsors moving in the right direction and, ultimately, it is the weight of all of us moving together that gets us to that tipping point that Maxime was referring to. It really is just having everything on the radar. That is what gives me a lot of comfort, we're moving in a direction that will enable greater transparency.*

Gifford: We have to recognize how far there is still to go. When we do talk to people, whether it is funds in China or even traditional asset managers in the United States, they still have no idea – or have a very sketchy idea – about the conversation that we have just had. They think it is still about ethical screening and you are either a real investor or you are an ethical investor doing it for social or political reasons.

This conversation is still very, very new to many mainstream investors.