Responsible investment: from trend to fundamental component

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Our world is undergoing a profound transformation. Globally, we're facing challenges that affect almost every part of society. Issues such as human rights, climate change, social inequality and corruption are causing us to rethink how we do things and even reinvent ourselves. Businesses are not immune; they must take non-financial issues into account to ensure sustainable growth. Responsible investment (RI) is also part of the new corporate governance principles defined in August 2019 by Business Roundtable. These principles advocate for a wider societal role for corporations, centred on the interests of clients, employees, suppliers, shareholders and communities. "It is the only way to be successful over the long term[1]," explains Jamie Dimon, Chairman and CEO of American investment bank JPMorgan Chase & Co.

Investors are watching this development closely and are proactive in adopting new ways of doing things that help create value over the long term. In this context, responsible investment is more than just a trend. By integrating a set of environmental, social and governance (ESG) criteria, it's a fundamental component of investments that foster inclusive, resilient and sustainable prosperity.

EXAMPLES OF ESG CRITERIA

Environmental

- Fight climate change
- Safeguard access to drinking water
- Preserve biodiversity

Social

- Enforce labour standards
- Respect human rights (e.g., child labour)
- Ensure social acceptability (e.g., First Nations)

Governance

- Promote board diversity
- Track executive compensation (e.g., incentives and bonuses)
- Recognize shareholder rights

Source: DGAM, March 2019

[1] Source: https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans

Desjardins Global Asset Management

The origins of responsible investment

As early as the 17th and 18th centuries, we saw what can be considered the beginnings of responsible investment on the basis of moral values and ethical principles. For example, Quakers, Methodists and other religious groups prohibited investments in companies related to manufacturing or selling arms, alcohol or tobacco products.

In the early 1970s, this line of thinking would extend to other social issues, including civil rights and women's rights. Then in 1977, the Sullivan Principles were published: a code of conduct to promote social responsibility among foreign companies operating in South Africa. The adoption of these principles led a number of American companies to cease operations in South Africa, contributing to the pressures that led to the abolition of apartheid in 1991.

Meanwhile, interest in environmental issues was on the rise. In 1987, the Brundtland report, entitled Our common future, was published—a watershed moment in the environmental movement, which gave rise to the term "sustainable development."[2] The environmental impact of industrial activities, greenhouse gas emissions, the use of mineral and energy resources, the depletion of arable land and the process of deforestation were becoming increasingly common concerns.

These movements encouraged investors to pay more attention to non-financial risks in managing their investments. While early on, choices were made on the basis of exclusionary principles only, over time this approach has reached a level of sophistication that now makes it possible to combine sustainability and financial returns—the very essence of responsible investment as we know it today.

[2] Source: Brian R. Keeble BSc MBBS MRCGP (1988) The Brundtland report: 'Our common future', Medicine and War, 4:1, 17-25, DOI:10.1080/07488008808408783

The movement is picking up steam

In recent years, responsible investment has been gaining in popularity as the methods used have evolved and it has become more sophisticated. ESG criteria and the opportunities created by taking those criteria into account are an integral part of investment processes, whether for active or passive management.

In fact, the 2006 United Nations Principles for Responsible Investment (PRI) currently has more than 3,000 signatories, representing assets of over $103 trillion.[3] A report by Morningstar estimated assets invested in sustainable investments to be C$8.8 billion at the end of the second quarter of 2020, while the estimate of net cash flows to ESG funds for the second quarter as a whole remained positive at C$135 million.[4]

This data reflects the increased interest in ESG issues among institutional investors' clients and beneficiaries. Given the coming multi-billion-dollar transfer of assets from the baby-boomer generation to millennials, who are even more focused on environmental and social issues, it is reasonable to believe that responsible investment could become the norm.

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[3] Source: https://www.unpri.org/pri/about-the-pri

[4] Source: Tam, Ian, 2020. *Le paysage de l'investissement durable pour les investisseurs dans les fonds canadiens.* Morningstar Research inc. https://www.morningstar.com

One philosophy, multiple approaches

While the proliferation of terms to characterize investing—ethical, responsible, thematic, sustainable, impact—can be confusing, it's good to remember that the number one priority when it comes to responsible investment is incorporating environmental, social and governance (ESG) criteria into security selection and asset allocation.

There are many ways to integrate ESG criteria into the securities selection and investment management process. Each investor will choose the approach or combination of approaches that correspond to their values and objectives.

Screening

Screening means avoiding certain types of investments to build a portfolio. It can be norms- or principle-based.

Norms-based screening is based on international standards, norms and treaties, such as the Convention on Cluster Munitions and the Ottawa Treaty banning anti-personnel landmines.

Principle-based screening applies to industries or companies whose revenues come from activities that run counter to the values advocated by the investor, such as the manufacture and sales of tobacco products.

Integrating ESG criteria

This approach involves evaluating a company based not only on financial criteria, but also on its ESG practices. This involves assessing the risks and opportunities associated with these practices and identifying areas that may impact the value of long-term investments.

As each industry, or even each business, is based on a unique business model, the ESG issues associated with it are also unique. After determining the issues specific to an industry or business, the portfolio manager can incorporate ESG criteria into the analysis and investment process to manage risk while pursuing return objectives.

The evaluation of corporate practices also allows securities to be selected from issuers with the best performance from an ESG criteria perspective. Among other things, this approach makes it possible to build a portfolio of some of the best securities in their category.

Thematic approach

A portfolio that uses a thematic approach includes securities that meet one or more ESG criteria. Portfolios might focus on diversity, climate change or human rights. Thematic portfolios aim to create long-term value while having a positive impact on the environment or society.

Impact investing

Impact investing means using funds to invest in businesses or projects that could have a positive and measurable environmental or social impact, while enabling financial objectives to be achieved. Health, affordable housing, microfinance and renewable energies are among the areas with opportunities for impact investments. In some cases, impact investments may constitute a thematic portfolio, just as a thematic portfolio may consist of impact investments.

Shareholder engagement

Shareholder engagement refers to all the ways that investors can influence the behaviour of the companies in their portfolios. Three main techniques are proxy voting, shareholder dialogue and shareholder proposals.

DGAM and responsible investment: staying at the forefront

Desjardins Global Asset Management (DGAM) uses an innovative approach to integrate RI into its investment solutions and remain among the leaders in this field. The portfolio managers and the RI team rate the financial health and ESG practices of companies in their investment universe. This requires comprehensive expertise in ESG analysis to assess risks and seize the identified opportunities. In other words, for DGAM professionals, RI is a continuous process that starts before a security is even selected and continues for as long as the security is held and beyond.

ESG CRITERIA IN FINANCIAL ANALYSIS

Source: DGAM, June 2020

Inspired by the United Nations Global Compact,[5] DGAM applies a first screening filter for securities selection as part of its responsible investment solutions. Other filters can then lead to additional screening based on the objectives and preferences of each partner and client.

Through an evaluation of business practices in conjunction with financial analysis, ESG criteria can be incorporated into DGAM's RI investment solutions. The RI team examines the risk factors associated with each sector and company and follows the guidelines set by, notably, the Sustainability Accounting Standards Board (SASB). It then analyzes the strategies adopted by the board of directors and company management to manage those issues. It closely monitors major controversies on the markets and, more importantly, the manner in which the affected companies respond. Based on the data gathered, the team assigns each company a rating that represents the degree to which ESG criteria are integrated into its management process and the efforts made to improve its practices. The portfolio managers use this classification to better evaluate companies from a securities selection perspective, favouring those with the best performance as well as those showing a desire to improve.

Depending on the mandate, the investment objectives can be set using a theme based on one or more ESG criteria. For example, some strategies set portfolio decarbonization targets or ESG ratings investment objectives. In this regard, Desjardins offers a series of exchange-traded funds aimed at reducing the portfolios' carbon footprint in order to support the transition to a greener economy.

[5] Source: https://www.unglobalcompact.org/what-is-gc/mission/principles

That being said, regardless of the ESG scope of each portfolio, DGAM takes advantage of shareholder engagement to encourage companies in the portfolio to improve their practices. Shareholder engagement allows DGAM to exercise one of its most important responsibilities: using its voice to help companies have a long-term, global vision.[6]

In the end, innovation, collaboration and dialogue are the keys to DGAM's approach to responsible investment. This gives us the knowledge and agility we need to adapt and stay at the forefront in a constantly changing world.

Towards a sustainable financial market

Regardless of how we approach responsible investment, we believe that capital must be at the service of human development, now more than ever. In fact, the Final Report of the Expert Panel on Sustainable Finance, published by the Government of Canada, echoes this sentiment. It concludes that the financial sector's aim should be to "connect the dots between Canada's climate objectives, its economic ambitions and its investment imperatives."[7] While the expert panel's mandate was to study the transition to a low-carbon economy, similar conclusions may be drawn regarding other ESG issues.

At the top of the chain, institutional investors have considerable power and influence, giving them a role and responsibility to ensure inclusive, resilient and sustainable prosperity. For DGAM, responsible investing is more than a trend: it's a fundamental component of our management philosophy. It helps create incentives to shift from a short-term perspective to a long-term, future-oriented vision of investing.

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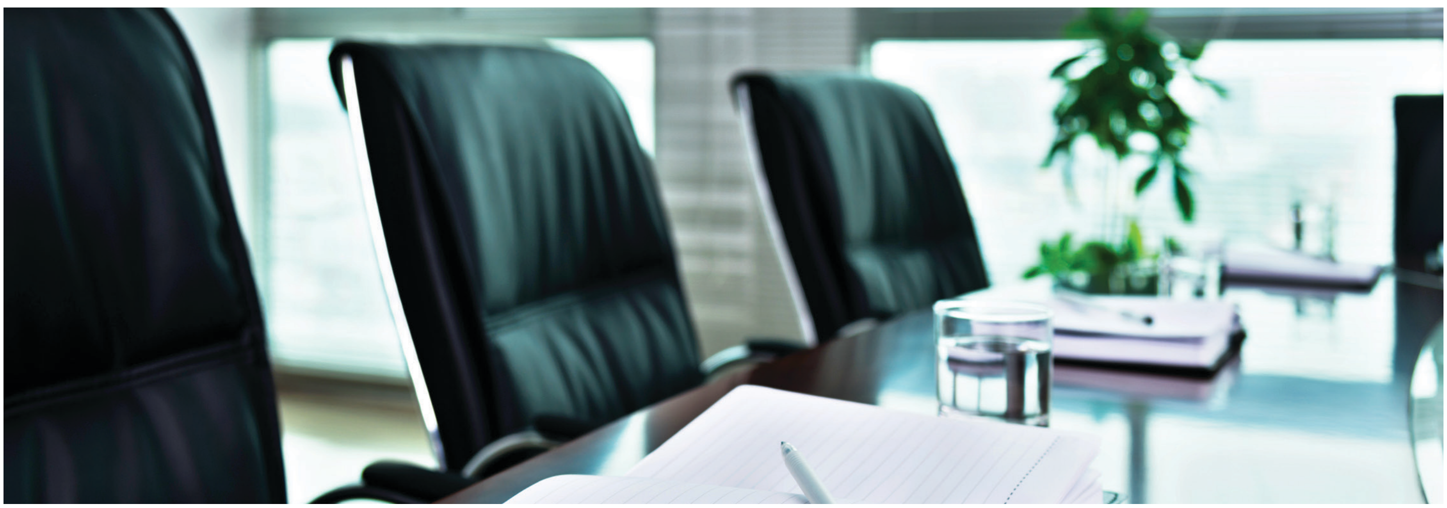
[6] Source: https://www.desjardins.com/ressources/documents/white-papier-engagement-actionnarial-e.pdf?navigMW=la&

[7] Source: http://publications.gc.ca/collections/collection_2019/eccc/En4-350-2-2019-fra.pdf



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