



ESG ROUNDTABLE

DOING BETTER WHILE DOING RIGHT

ESG IS MORE THAN GOOD INTENTIONS –
IT'S SOUND RISK MANAGEMENT



BLACKROCK®

Canada's largest pension funds are leaders in the environmental, social and governance investment (ESG) space – but many small plans are missing from the conversation. And while regulatory initiatives are providing a helpful push in the right direction, implementation remains a challenge for all but the biggest pension funds in Canada.

That was a key finding at our ESG Roundtable, where experts gathered to share their views on the state of ESG-focused investing in the Canadian pension space. The good news is that, despite the challenges facing some plan sponsors on the implementation front, a strong momentum for change is already in place, as governments and industries around the world shift the focus to more sustainable models and to tackling the realities and costs bred by unchecked climate change.

If you're worried about what's happening south of the border, don't expect a Trump-like backlash to disrupt that forward momentum any time soon – with the rest of the world moving ahead, ESG criteria will simply be part of the decision-making fabric of any institutional investment strategy, not just among defined benefit (DB) plans, but in the defined contribution (DC) space as well.

When that happens, ESG-focused roundtables like this one will become obsolete!

EXPERT PANEL

Moderator and writer:

CAROLINE CAKEBREAD, Editor, *Canadian Investment Review*



HYEWON KONG, CFA
Associate Portfolio Manager
AGF Investments Inc.



VINCENT ROY, CFA
Head of Canadian
Scientific Active Equity
BlackRock



MARTIN LECLAIR, CFA
Vice President
Proteus Performance



ROBIN STANTON, CFA
Vice-President,
Investments
AGF Investments Inc.



KURT REIMAN
Chief Canadian
Investment Strategist
BlackRock

IS ESG INVESTING ABOUT STEWARDSHIP OR FIDUCIARY DUTY? AND CAN PLAN SPONSORS IN NEED OF SUFFICIENT RETURNS RECONCILE THE TWO?

Martin Leclair

I think that educating themselves about ESG is part of their fiduciary duty right now – and there is a lot more education that needs to be done. ESG is much more than just negative screening; ESG is far more complex. The Ontario Pension Benefits Act now requires plans to file annual investment policy statements with wording about the use of ESG. That's a first step toward broader acceptance and use – and in five years it's going to be a completely different landscape. The political powers want us to start thinking about ESG, so if you are a plan sponsor, there's no way around this. It is part of your fiduciary duties.

Robin Stanton

Fiduciary duty and stewardship are becoming interchangeable. ESG is very much about your fiduciary duty to plan beneficiaries. With respect to the stewardship of pension assets, I'm not sure that plan sponsors are quite there yet in their thinking, but regulators seem to be moving in that direction.

Vincent Roy

It's also important to understand that ESG has been shown to add value for the longer term. It's not just about bottom-line returns – it's also about long-term value.

IN THE CONTEXT OF FIDUCIARY DUTY, WHAT IS THE VALUE OF ESG TO PLAN SPONSORS?

Martin Leclair

From an investment perspective, it's simply better risk management and better risk-adjusted returns. Every portfolio manager knows this and is acting accordingly. When managers analyze a company, they look at the financial factors and they also look at the non-financial factors. For example, on the governance front, investors always look at the board, at engagement and compensation. Environmental factors are also important now: there are companies already being hurt by climate change. For example, non-recoverable financial losses for insurance companies sit at about \$50 billion annually.



“It is also important to measure the cost of extreme weather. Research has been done to link billion-dollar disasters to local GDP, which has been shown to suffer for a year or two after an event.”

– VINCENT ROY

Hyewon Kong

There are also opportunities in ESG. Megatrends are taking hold on the environmental and social side – for example, consumers want products that support their demand for a healthier lifestyle. In this low-growth environment, you need to look for those drivers of future growth – ESG is a tool to help identify them.

Kurt Reiman

Pension plans now face lower returns from traditional asset classes. Companies that embrace ESG are typically those that exhibit operational excellence. That means they've reduced their carbon

exposure on a relative basis and have outperformed companies that haven't taken the same steps. That matters. ESG can be a helpful metric for investment managers at a time when future return assumptions are much lower.

Martin Leclair

ESG isn't a switch that you can flick 20 years from now and say, "Oh, I guess I'm going to care now." Plan sponsors need to care today, adapt today, because this is where the world is going.

ESG IS A DECIDEDLY LONG-TERM PROPOSITION. HOW CAN INVESTORS RECONCILE THIS WITH A WORLD WHERE SHORT-TERM THINKING SEEMS MORE PREVALENT IN THE INVESTMENT WORLD?

Vincent Roy

People have definitely shortened their time horizons. But we also know that longer-term fundamentals will add value: ESG provides another long-term view of a company, where the market will ultimately reward firms that are the best stewards of their own assets, that manage their carbon footprint and their water usage, and that treat the community and their employees well. All this should show up as being value-added down the road.

Hyewon Kong

Mark Weisman and Dominic Barton have argued that so-called quarterly capitalism is killing the economy and that long-term investors like pension funds are crucial to ending the kind of short-termism that plagues corporate decision-making. But plan sponsors also need to understand that there is a disconnect between their time horizon, which spans



decades, and that of their investment managers. What happens if a manager underperforms over a year or a quarter? What does that mean to the plan sponsor and what actions should they take? This relationship also needs to be addressed and long-term performance has to be incentivized.

Kurt Reiman

But is it really a conflict? Because you can now reduce the carbon intensity of the MSCI world by 70% and still perform within 30 basis points of the index. Why wouldn't you do that, especially if you believe that carbon is a risk? Otherwise, you could end up with stranded assets in your portfolio, or you could have a portfolio that is highly sensitive to regulatory change.

WHY AREN'T MORE PLAN SPONSORS FURTHER AHEAD IN INTEGRATING ESG INTO THEIR INVESTMENT PROCESS?

Martin Leclair

There's a lot of inertia. The question is always, "Is it really adding value?" The status quo is always very appealing, especially when you go into something that you don't know about. A lot of plan sponsors still think that ESG is the old Socially Responsible Investing (SRI) – negative screening and that's it. They need to understand that it's far from that – that probably 80% of a company's value is determined by non-financial factors. ESG plays a role; it's not a marketing fad.

Kurt Reiman

There is also a barrier around the definition of ESG. When you come to this topic, people will ask, "Do you mean impact investing?" "How big is the umbrella?" "What are you talking about?" The awareness is there, but there's still some ambiguity. There is also the subjectivity of ESG. When it's a financial factor, you plug in a number and assess based on that. But how do you quantify ESG factors? There is a clear lack of standards in the data and it's often self-reported by managers or the company. That can make it subjective.

Robin Stanton

Kurt is right – if some aspect of the data doesn't look too good, a company can decide not to report it. But if companies were mandated to report good and bad news, then you actually have a full picture – it would be very helpful. It's all about transparency and access to information for us to actually be able to quantify and to calculate what the risks are for each firm.



WHAT ARE THE IMPLEMENTATION CHALLENGES WITH ESG – HOW EASY IS IT TO INTEGRATE INTO A PLAN’S STRATEGIC ASSET ALLOCATION?

Hyewon Kong

Initiatives like the Sustainability Accounting Standards Board and the Task Force on Climate-related Financial Disclosures are really important in addressing the data challenges we talked about earlier. Right now, investment managers have to rely on less concrete metrics to determine whether a company is really making a positive impact – pollution data or water and land usage numbers, for example. There are so many questions that arise in the absence of direct data. How can we as investment managers compare different companies? Or sectors? How can we generate alpha? Right now, we create these opportunities by engaging with company management to better understand where a company is headed.

Kurt Reiman

The barriers to implementing are huge and plan sponsors take this issue very seriously. But it is changing. We can do things today that couldn't be done just a few years ago – portfolios can now be screened for ESG and for low carbon. ETFs are another tool that can be used to build fixed income and equity portfolios.

Martin Leclair

The big questions for plan sponsors are, “How can we implement?” “Does ESG mean I have to change my portfolio completely?” “What are the products out there and what are the fees?” A number of companies have been ahead of the curve and have been quite active in the space for a long time. But I think that the market, generally speaking, has been slow to bring out the products that will help plans to adopt ESG. This could be because there's not as much demand, but without the products it's going to be hard to kick-start more demand. ESG can remain an elusive concept for smaller plan sponsors and very difficult to implement. The mega plans have what they need – but large- and mid-size plans need to do their homework and work hard to find those quality investment products. This is about portfolio construction and we're slowly getting there.

Vincent Roy

There is a question of trust – how can plan sponsors trust that their investment managers are actually looking at these things? If it's labelled ESG or

“It’s overwhelming for a lot of plans. If you’re a \$2 billion or \$5 billion pension plan with a staff of three or four, you’re potentially talking about a change to the plan’s overall asset allocation. It’s not just equities and fixed income – you have a real estate portfolio, possibly private equity and infrastructure to also consider.”

– ROBIN STANTON

responsible investing, plan sponsors need to know that a manager is delivering that. But in many cases, there is no proof statement that a given portfolio enables better societal outcomes than a non-ESG alternative. You need to be able to show some metrics and prove that this approach is better. Plan sponsors can't always know how much bang they're getting for their buck – and in many cases, the fees have been higher for these portfolios.

Martin Leclair

Trust is extremely important. Think about Volkswagen – in the context of an ESG scorecard, it was rated quite high. It was seen as a great company. Then the emissions scandal happened and the company lost 60% of its value. Events like this create a cloud around ESG – they demonstrate the complexity and limitations of the approach. Incorporating ESG factors is the right thing to do, but it's no guarantee against extreme events.

Robin Stanton

It's overwhelming for a lot of plans. If you're a \$2 billion or \$5 billion pension plan with a staff of three or four, you're potentially talking about a change to the plan's overall asset allocation. It's not just equities and fixed income – you have a real estate portfolio, possibly private equity and infrastructure to also consider. Some tend to view it as all or nothing – they think there's no point if they just apply ESG to a portion of the assets while ignoring real estate or private equity where there could be other issues and risks. Rolling ESG out across an entire portfolio is a challenge and some more education is needed in this area. On the asset management side, product solutions tend to fit with certain buckets – but they can create challenges in other parts of the portfolio. More demand is needed to support more product



development, and those asset flows haven't been there for managers to respond with new products. It's a bit of a chicken and egg conundrum.

HOW DO YOU MEASURE ESG RISKS – CLIMATE CHANGE, FOR EXAMPLE?

Kurt Reiman

There is still a lot to be learned. It's not like all carbon emissions are accounted for. We're really only talking about those carbon emissions that are in the supply chain. The companies under the greatest pressure to disclose are public companies – but private companies are less likely to give that information. Also, what about carbon emissions in the lifecycle of a product? They're just as relevant. We know a lot more today than we did, but there is still a lot more information to be gathered.

Vincent Roy

That's very true. There will be pressure to penalize a power plant because of its emissions, but the manufacturing company located right beside it for access to coal power gets a free pass to some extent because the two are not linked by data. Risk measurement criteria need to be broadened so these things are factored in. I think that will change eventually, but right now when you're just looking at these scores, one gets penalized and the other one doesn't.

Hyewon Kong

We also penalize the producer but not the consumer.

Kurt Reiman

Same problem when comparing developed and emerging markets, many of which get very poor scores on carbon emissions when, in fact, all they're doing is manufacturing goods that are ultimately consumed in developed market economies. There is this global supply chain, and carbon emissions are routinely measured at the source rather than in the final consumption or in relation to the lifecycle of the product where they're being used.

Vincent Roy

It is also important to measure the cost of extreme weather. Research has been done to link billion-dollar disasters to local GDP, which has been shown to suffer for a year or two after an event. It could be possible to link firms operating in those regions or areas and quantify the impact and identify investment opportunities.



“When it’s a financial factor, you plug in a number and assess based on that. But how do you quantify ESG factors? There is a clear lack of standards in the data and it’s often self-reported by managers or the company.”

– KURT REIMAN

HOW DO CANADIAN PLAN SPONSORS RANK RELATIVE TO THEIR GLOBAL PEERS IN THE ESG SPACE? IS CANADA’S RESOURCE-FOCUSED ECONOMY A BARRIER?

Hyewon Kong

For large pension funds in Canada, ESG is a big part of what they do. Many of them have ESG specialists who are helping portfolio managers across different asset classes. They are also leading some of the conversations on ESG issues and engagement – OPTrust, Teachers’, and CPPIB, which has been

named to the Task Force on Climate-related Financial Disclosures. The question is, how can we reduce the gap between the large and the small plan sponsors in Canada?

Martin Leclair

I like to believe that Canada will be an aggressive adopter of ESG because of our culture and demographic. We have plenty of examples of clean energy producing companies here in Canada. We also have very large labour organizations that tend to be pro-sustainability. As for the oil industry, Canadians have been very vocal in their views on the pipeline and the oil sands. Canadians want solutions, and big pension plans have the power and money to influence the course of history – it’s just a matter of time. Canada will be a massive adopter of ESG; I truly believe that.

Vincent Roy

The trend in Canada is to view ESG as a risk-management tool rather than a values-based investment approach. CPPIB and Teachers’ are leaders in that regard.

HOW CAN ESG INVESTORS TAP INTO EMERGING ECONOMIC AND TECHNOLOGY TRENDS?

Robin Stanton

There’s a huge push for infrastructure spending over the next number of years, especially in Canada and the U.S. A lot of it is refurbishment and revising what’s already there, whether it be a LaGuardia Airport or others. All of this needs to be brought up to date and be made cleaner. At the same time, in emerging markets, there are huge opportunities in clean energy production – and also to build smarter cities and high-speed rail. As the developing world applies new technologies and approaches to build infrastructure and cities, it can leapfrog 30 or 40 years ahead of the developed world as it builds from a greenfield point of view. Here in North America, we’re at an interesting transition point as we deal with legacy issues like coal before a cleaner environment or cleaner economy can prevail.

Hyewon Kong

Pollution is a huge social risk in emerging markets. The Chinese government, for example, is very concerned with the social unrest it causes. China is now one of the largest markets for clean energy. China is investing in clean technologies and India

has followed. Another big area of growth will be real estate – what are we doing to make buildings energy-efficient? There are huge opportunities here – smart lighting for example. The electrification of cars is also proving highly disruptive to the traditional car model. The technology is now more affordable as the costs come down – that will enable higher adoption.

LET'S TALK ABOUT TRUMP. WHAT KIND OF IMPACT COULD HIS POLICIES HAVE ON ESG, PARTICULARLY ON THE ENVIRONMENTAL FRONT?

Martin Leclair

I believe in the power of institutions – no one is going to stop the momentum toward sustainable investing and renewable energy, because Generation X and millennials are already behind it. They are pushing that trend.

Vincent Roy

ESG is a global phenomenon – the U.S. is a big part of the global push, but if you look at where it's been adopted, the U.S. has not been a big leader.

Kurt Reiman

The ESG momentum is going to continue. The firms that have committed to reducing their own emissions will continue to do so. They will continue to reinvest in renewable energy. This is a longer-term trend that extends beyond a presidential term.

Hyewon Kong

If Trump adopts all the policies he's promised, it's certainly a setback in terms of climate issues. According to Lux Research, two terms of Trump's policies would result in emissions that are 16% higher than two terms of Clinton. That will amount to 3.4 billion tons of more emissions over the next eight years. But I believe we are just overemphasising the government policy – ESG portfolios don't have to rely on subsidies. The U.S. can pull out of the Paris Agreement or other treaties, but every single participant is sticking with the plan. On the upside, Trump is emphasising social issues and jobs – that could certainly give a boost to the social part of ESG.

Kurt Reiman

We have to remind ourselves that regulation and policy exist as a catalyst for change. Yes, regulation is needed, but technology is already creating market forces that are reducing carbon. Social forces and

corporate awareness also act as catalysts for change when governments don't. And as the physical risks of climate change become more obvious and costly, there will be more momentum for change.

HOW DO YOU SEE ESG INVESTING EVOLVING IN CANADA IN THE FUTURE?

Kurt Reiman

I think that investors are going to take a total portfolio approach to incorporating ESG – improving the standards around data reporting will help in this regard. You can now create ESG or carbon-optimized or carbon-aware portfolios across asset classes and bring them together into a total portfolio. Investors



“ESG isn't a switch that you can flick 20 years from now and say, “Oh, I guess I'm going to care now.” Plan sponsors need to care today, adapt today, because this is where the world is going.”

– MARTIN LECLAIR

have been asking for this for a long time, and it's only recently become available. In the future, maybe ESG just becomes one of those things that everybody considers and doesn't even think about anymore – it becomes a basic part of portfolio management. And we don't have roundtables like this one discussing the importance of ESG.

Martin Leclair

There is a huge opportunity to make sure DC plans adopt ESG. The conversation needs to move in this direction – this is where the growth is. Big DB plans will always be around, but you need to have DC plans on board as well – after all, they are the prevalent pension vehicle of Gen X and millennials. To do this, we need to figure out how to introduce ESG factors into target-date funds and into the other options members can select from. To me, that's key: if you want to keep building that momentum, especially in the U.S. and Canada, where DC assets are growing, you need to have them adopt it. We aren't there yet.

Robin Stanton

Let's first consider the DC platforms – they often look to their consultants for feedback on who should be on their investment platform. We are seeing some major consulting shops staffing up with expertise on impact and ESG so they can do the due diligence on the managers and recommend ESG products. And then obviously the record keepers and the sponsors need to build up their expertise. It's a question of how to get the DC clients and ultimately the participants to opt into a pooled or mutual fund vehicle with an ESG theme.

Martin Leclair

It has to be integrated and adopted at the fund management level – it doesn't need to be labelled. I think we are past that point. I can't see starting to educate plan members about ESG options and allowing them to choose. Plan sponsors need to take ownership of this. The U.S. is in a far better situation, because target-date funds have been more widely adopted – you could make a significant change by ensuring that those target date funds comply with ESG. In Canada, we're not there yet. So there's the opportunity.

But imagine if one record-keeper was to say, “My platform is ESG compliant.” That would send a massive signal – and I'm sure that this record-keeper would be phenomenally successful. ■



“If Trump adopts all the policies he's promised, it's certainly a setback in terms of climate issues. According to Lux Research, two terms of Trump's policies would result in emissions that are 16% higher than two terms of Clinton. That will amount to 3.4 billion tons of more emissions over the next eight years.”

– HYEWON KONG



BLACKROCK®

About AGF Investments Inc. (AGF)

AGF is an independent firm, we strive to help investors succeed by delivering excellence in investment management and providing an exceptional client experience. AGF has investment operations and client service teams on the ground in North America, Europe and Asia. This strong regional presence provides our clients with timely knowledge, insight and understanding of global markets.

Being an independent firm has allowed us to make strategic acquisitions that improve our client service, enable us to offer new innovative products and enhance our research capabilities.

Our suite of diverse investment solutions extends globally to a wide range of clients, including pension plans, corporate plans, sovereign wealth funds and endowments and foundations.

About BlackRock

BlackRock is a global leader in investment management, risk management and advisory services for institutional and retail clients. At September 30, 2016, BlackRock's AUM was US\$5.1 trillion. BlackRock helps clients around the world meet their goals and overcome challenges with a range of products that include separate accounts, mutual funds, *iShares*® (exchange-traded funds), and other pooled investment vehicles. BlackRock also offers risk management, advisory and enterprise investment system services to a broad base of institutional investors through *BlackRock Solutions*®. As of September 30, 2016, the firm had approximately 13,000 employees in 30 countries and a major presence in global markets, including North and South America, Europe, Asia, Australia and the Middle East and Africa. For additional information, please visit the Company's website at www.blackrock.com/ca | Twitter: @BlackRockCA | Blog: www.blackrockblog.com/can

About iShares

iShares® is a global leader in exchange-traded funds (ETFs), with more than a decade of expertise and commitment to individual and institutional investors of all sizes. With over 700 funds globally across multiple asset classes and strategies and more than \$1 trillion in assets under management as of September 30, 2016, *iShares* helps clients around the world build the core of their portfolios, meet specific investment goals and implement market views. *iShares* funds are powered by the expert portfolio and risk management of BlackRock, trusted to manage more money than any other investment firm.¹

¹ Based on US\$5.117 trillion in AUM as of 9/30/16.