# THE VIGIL

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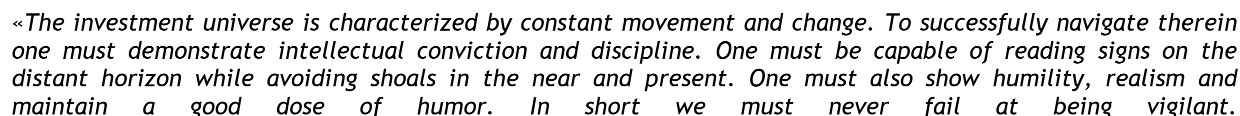
## Is responsible investment about to transform the corporate environment?

In this edition of the Vigil, we look into the three key trends behind the recent growth of responsible investing, and we look back on the progress made so far to promote awareness of responsible investing issues.

*"VIGIL: from the latin 'Vigilare'. Keeping awake at a time when sleep is customary; an act of watching; surveillance" – Merriam Webster*



*«The investment universe is characterized by constant movement and change. To successfully navigate therein one must demonstrate intellectual conviction and discipline. One must be capable of reading signs on the distant horizon while avoiding shoals in the near and present. One must also show humility, realism and maintain a good dose of humor. In short we must never fail at being vigilant.*

*Those qualities are brought forward daily by Natcan's team of professionals. The following commentary reflects the views and opinions of our team on issues impacting Canadian investors and their advisors. »*

- Pascal Duquette, president and CIO

## >>> NATCAN

Founded in 1990, Natcan Investment Management Inc. is a subsidiary of the National Bank of Canada with approximately 30 billion dollars under management. Natcan is one of the premier institutional money managers in Canada. Our investment leaders follow their convictions with discipline and rigour to serve the best interests of our clients and their financial advisors.

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The world of responsible investment has greatly evolved since the turn of the new millennium. Faced with this growing movement, ex-Secretary-General of the United Nations Mr. Kofi Annan invited a group of 20 leading institutional investors from 12 countries to join a process to develop the Principles for Responsible Investment (UNPRI), the first international guidelines to oversee the various efforts of numerous investors. Some 32 signatories, representing US$2 trillion in assets, answered the call at the initial unveiling of the guidelines in April 2006. Today, there are over 275 adherents, for assets exceeding US$13 trillion.

Composed of 6 voluntary and aspirational best-practices for responsible investment, the initiative invites investors to incorporate environmental, social, and corporate governance (ESG) issues into their security selection and holding processes. Beyond numerous specialists whose adherence to the Principles was foreseeable, the most astounding was the commitment of generalists associated with names such as HSBC, JPMorgan, Deutsche Bank, ABN AMRO, Mizuho, Société Générale, Swiss Re, and BNP Paribas. In light of this surprising and echoing success, one can ponder the reasons behind such enthrallment for responsible investing, despite historical prejudices.

Our hypothesis implies that three key trends that developed over several years converged in the past 12 to 24 months, and that this junction is behind the sudden ebullience of responsible investment:

- increased public awareness;
- pertinence of the newly available information; and
- actual proof of the positive link between ESG and financial performances.

**INCREASED PUBLIC AWARENESS**

This first trend is certainly the easiest to recognize. During the current decade, each of the three ESG facets had to deal with events that threw them into the spotlight.

The issue of corporate governance became a hot topic of discussion when a series of scandals started in 2001, giving new meanings to the terms “independence”, “ethics”, and “fiduciary duty”. Beyond the Sarbanes-Oxley Act introduced in 2002, investors’ increased interest in corporate governance issues had an enormous impact on companies’ operational framework. Today, investors routinely monitor governance-related policies, procedures, audits, and reports.

Social responsibility awareness arose as a result of the economic growth in emerging countries - furthered by China’s accession to the WTO (World Trade Organization) in December 2001 - and its predominance across financial headlines. The recent wave of globalization has indeed shined the spotlight on a series of social risks to which western companies were hardly exposed until they decided to take advantage of emerging market opportunities. Risks related to corruption, human rights infringement, the implementation of acceptable labour standards, and the consultation of local populations are examples of elements investors now need to monitor carefully.

The ESG awareness process was completed in 2007 with an unprecedented increase of public interest in climate change. For the first time, climate change shed its strictly environmental persona to also be regarded as an economical phenomenon. The Canadian Council of Chief Executives (CCCE) has in fact declared that “within this broad environmental and economic challenge […] climate change represents the most pressing and daunting issue”. This recognition of both the challenge and its economic aspect increases its significance in the eyes of a variety of stakeholders. Findings published in the Stern Review - the largest and most widely known report to discuss the economic impact of climate change - Intergovernmental Panel on Climate Change’s (IPCC) scientific reports, and the movie An Inconvenient Truth - for which Al Gore received the Nobel Peace Prize (jointly with the IPCC) - were additional catalysts that helped bring climate change to the forefront of public attention. Finally, an increase in global media coverage heightens the feeling of urgency to adopt mitigation and adaptation measures.

This increased public awareness toward the importance of corporate responsibility factors propelled governance issues to the top of political agendas throughout the world. As a result, the corporate world now faces considerable pressures as it needs to factor in changes that are about to significantly transform its environment. Companies that can

best prepare and adapt to these changes will likely reward investors with superior returns.

**PERTINENCE AND AVAILABILITY OF INFORMATION: A HEFTY CHALLENGE**

To successfully take advantage of an opportunity, one must have access to quality information. Unfortunately, one of the main obstacles responsible investment has always had to face is the difficulty - even impossibility - to access information that is comprehensive, reliable, standardized, and comparable. Considerable progress has nonetheless been made throughout the years, and the information that is being published today allows for a more transparent and objective integration of companies' ESG performance to traditional financial analysis. This trend is all the more perceptible among the increasingly popular initiatives that have recently emerged and managed to become references in their respective field of expertise.

The Global Reporting Initiative (GRI) - initiated by CERES - is a multi-stakeholder network aiming to provide the global standards in sustainability reporting through a voluntary framework. When the first reporting guidelines were published in 2000, 50 organizations released sustainability reports based on the GRI's recommendations. Today, after two revisions of the framework, over 1,000 organizations have declared their voluntary adoption of the Guidelines, in addition to those that use them as a reference. Of those that have conformed, we find 64% of the top 100 companies of the world, identified as such by FT, Forbes, and Fortune, including global leaders Microsoft, Coca-Cola, IBM, General Electric, and Nokia. The GRI seeks to entrench ESG reporting into companies' routine practices, to the same extent as financial reporting. Over the past few years, it has become the *de facto* global standard for companies that wish to report information that is comprehensive, liable, standardized, comparable and, most especially, usable for investment purposes.

The Carbon Disclosure Project (CDP) is a not-for-profit organisation aiming to unite investors to ask the world's largest companies (3,000 in 2008) to reveal:

- their impact on climate change;
- the impact of climate change on their activities; and
- their way of managing the risks and opportunities that arise from climate change.

With over 8 years of experience, CDP now comprises more than 385 signatories, representing more than US$57 trillion in assets. Besides all the questionnaires sent to companies each year on an array of topics, the CDP has become the standard for carbon disclosure methodology and process. More and more, companies that do not answer these questionnaires are being singled out by the investment community. In addition to providing important information to shareholders, this initiative has forced a great number of corporations to seriously address a phenomenon whose impact on corporate results can only escalate over time.

The Enhanced Analytics Initiative (EAI) is an international collaboration between asset owners and asset managers whose goal is to pool resources to further ESG research in sell-side brokerage firms. It seeks to provide market incentives to encourage better investment research, which is vital to the integration of ESG factors in traditional financial analysis. EAI, representing US$3.0 trillion in total assets under management, has convinced reputable firms such as Goldman Sachs, Bear Sterns, Deutsche Bank, and JP Morgan to allocate more and more resources to researching the impact of extra-financial issues on investment. Since its inception a little over three years ago, EAI has contributed highly valuable material for investors all the while enhancing the credibility of responsible investment throughout the investment community.

Each in their own ways, these three initiatives have helped legitimize the integration of ESG criteria to traditional financial analysis by combining characteristics that made financial information successful: pertinence, reliability, transparency, comparability, timeliness, and objectivity. The road toward information that is reported, recognized, and used by all participants is long and treacherous. However, progress made in the past decade allows for a more efficient integration of the extra-financial elements that will shape the future corporate environment to the investment decision-making process. As such, we currently stand light years away from what was achievable five years ago, and conceivable ten years ago.

## ESG PERFORMANCE VS FINANCIAL PERFORMANCE

The relationship between ESG factors and financial performance is the missing link that has allowed ESG integration to spread across the investment community. Though numerous conflicting studies have been published on the topic, the new environment surrounding responsible investment became conducive to pursuing this relationship once again.

As such, United Nations Environment Programme Finance Initiative (UNEP FI) and Mercer have compiled the results of 20 academic studies and 10 broker studies covering different responsible investment approaches whose findings were published in *Demystifying Responsible Investment Performance* in October 2007. The results: 87% of the research reviewed showed evidence of a neutral to positive relationship between ESG factors and portfolio performance, while 46% confirm a strictly positive link. What's more, looking only at the seven studies pertaining to the strategic integration of ESG factors to traditional financial analysis, all find a neutral to positive link, of which 71% are strictly positive.

Combined to the Freshfields report published in 2005 by Freshfields Bruckhaus Deringer (the report found that throughout all jurisdictions reviewed, the integration of ESG considerations to traditional financial analysis was certainly permitted and arguably required of fiduciaries), this UNEP FI study seals the third great trend behind the intensifying enthusiasm for responsible investment: the acknowledgment of a positive link between ESG factors and financial performance.

## CONCLUSION

The road recently travelled toward the advancement and propagation of modern responsible investment approaches as standardized by the UNPRI is impressive. Though none of the three key trends discussed here would have been able to single-handedly trigger this success, the thought process that leads us to believe their recent crossing helped lay the foundation for this success is clear.

- Increased public awareness helps place several ESG considerations at the top of political agendas, and significantly influences the evolution of the corporate world.
- Through the pertinence of the information available today, investors can identify companies that will stand out and demonstrate they can anticipate and efficiently address the issues at hand, thus generating durable competitive advantages.
- Contrary to what we have seen in the past, this theory seems to be increasingly confirmed by the practice, corroborating the fact that the strategic integration of ESG factors in traditional financial analysis is likely to translate into superior long-term performance.

In view of such findings, it seems vital for today's investors to thoroughly understand the new dynamics of corporate financial performance and companies' determination to understanding and proactively managing the risks and opportunities revealed by ESG considerations. The fact that much time will have gone by before ESG integration becomes a norm for the majority of shareholders reveals a potential market inefficiency from which shrewd investors will likely profit until the others jump on the bandwagon. Ironically, it is only when this opportunity will have faded on due to its widespread acceptance that the impact of investors on corporate responsibility will reach its peak.

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