Hand in Hand: Sustainability and Performance - Part 1

Vicki Bakhshi - Director in the Governance and Sustainable Investment team at BMO Global Asset Management (EMEA)

Environmental, Social and Governance (ESG) investing has been demanding ever more attention in Canada – and globally. Vicki Bakhshi, Director in the Governance and Sustainable Investment team at BMO Global Asset Management (EMEA), shares her insights on what's behind the momentum, the range of ESG strategies available, and the biggest trends and challenges ahead as we move toward building a more sustainable financial system.

Taking Moral – and Financial – Values into Account

As climate change policies and governance issues become heated topics of debate in the media, ESG investments have expanded rapidly across the globe, with the consideration of these issues in an investment context essentially becoming a *mainstream approach*, particularly in the last five years – rising up in the agenda of regulators, investors, consultants and asset managers.

The biggest driver of this acceleration of global interest has been the realization that ESG issues (*such as corporate governance, labour and environmental standards*) are not simply about moral or ethical values at the possible expense of financial performance, but that ESG considerations can actually support – and enhance – long-term returns, from both a risk management and opportunity standpoint. There has been plenty of compelling evidence to support this claim, from academic studies to real-life examples where environmental risk factors have had detrimental financial impact. A mere glance at newspaper headlines will confirm this: whether it's the multi-billion dollar fines paid by pharmaceutical companies for unethical marketing practices, the failings in risk management and governance that continue to burden the banking sector, or the financial and reputational impact to BP following the Deepwater Horizon oil spill.

But it's not all about risk. Macroeconomic mega-trends, including the expanding and ageing global population, the impacts of climate change, biodiversity threats and urbanization present unprecedented social and environmental challenges. Companies providing solutions to these challenges can position themselves to benefit from growth opportunities, resulting in the potential for alpha generation. For investors, having an understanding of these sustainability trends can help support successful long-term stock selection.

Having an understanding of sustainability trends can help support successful long-term stock selection.

That's the intuition – but is it borne out in practice? A growing body of evidence suggests that the answer to this question is YES – and that far from there being a trade-off between ESG and performance, as was the concern previously, the two can actually work hand-in-hand. One recent study by the University of Oxford and Arabesque Asset Management that reviewed 190 independent academic papers, found that 88% showed a positive link between robust sustainability practices and stronger company-level operational performance.[1]

Opening the Door to a Range of ESG Strategies

With the myth of ESG investments harming financial performance sufficiently debunked in recent years, increasingly more institutional investors are integrating these considerations across their portfolios, and throughout different asset classes, especially as recent regulatory and public policy initiatives move to mandate this necessary step change in behaviour.

What's New in ESG Regulation?

1. Following an amendment to the *Ontario Pensions Benefits Act*, all Ontario-Based Defined Benefit pension plans are now obligated to include information about whether, and how, they consider ESG issues in their *Statement of Investment Policies and Procedures (SIPP)*.
2. Launched by Bank of England Governor Mark Carney, the Financial Stability Board's (FSB) Task Force on Climate-Related Financial Disclosures published recommendations for consultation in December, with the final report due in June. While the FSB recommendations do not carry legal force, expected endorsement by G20 leaders later this year will assign significant political clout.
    - Recommendations state that financial institutions – including pension plans and asset managers – should be able to describe the main climate-related risks and opportunities they face, including scenario planning for limiting global temperature rise to 2 degrees Celsius, and publishing their carbon footprint amid the transition to a low-carbon economy.

Amid these changes, the investment industry continues to respond through a variety of responsible investing implementation strategies – ranging from **exclusion mandates to positive, impactful ESG investing**, and **active engagement initiatives** to encourage best practices. Ethically screened, or "exclusion" funds are the ideal option for investors seeking to avoid certain activities that conflict with their principles, such as fossil fuels, tobacco or weapons producers, while thematic-oriented investing is suited for those focused on selecting companies that are the sustainability leaders of the future and provide solutions to global sustainability challenges – in sectors like health care, clean technology, waste management or natural resources.

ESG Trends: Quantifying Impact and Improving Data Quality

One of the biggest trends – and challenges – ahead for the ESG movement is how we can effectively report on impact, and find ways to determine how the companies we're investing in are helping to support common sustainability goals. There's greater demand than ever before from investors to know what they're positively investing their money in – much like the fair-trade coffee movement, or ethically sourced clothes. As a result, many asset managers are now assessing their progress against the framework of the Sustainable Development Goals (SDG), a list of 17 global goals agreed to in 2015 that cover issues such as poverty, health, decent work and clean energy. The challenge now is place some reliable, measurable quantification to the analysis, so that asset managers and investors are able to understand what it means for a company to be a strong or weak ESG performer, and the impact of their activities. To this end, our specialist London-based Governance and Sustainable Investment (GSI) team just released the ESG Profile and Impact Report 2017 for our BMO Responsible Global Equity strategy, enhancing reporting to include an assessment of our Fund's connection to the SDGs, analysis of the ESG profile, and a carbon risk assessment.

One of the biggest challenges ahead for ESG investing is how we can effectively – and measurably – report on impact.

Another trend beginning to materialize is the movement toward integrating ESG considerations across a wide range of asset classes – from private equity to fixed income, and not simply as specialist strategies. As this develops, while there's been an explosion of quality ESG data, investors are still grappling with how to translate and interpret this into genuinely relevant information that can apply across an entire portfolio. To help with this effort, BMO Global Asset Management consistently shares the expertise of its London-based GSI team, ensuring that fund managers are able to discuss how to intelligently utilize the data provided to feed reliably into valuation processes and enhance mainstream investment analysis.

Still, more efforts need to be undertaken, particularly with filling in substantial gaps in coverage for emerging and small-cap companies – where disclosure and data quality is not consistent, even between companies operating in the same industry. In the meantime, the role of ESG experts within asset management firms, such as our specialist GSI team, will be vital to seeing beyond the surface presentation, and interpreting the existing data to determine important investment information.

From G to ES in ESG

- Up until recently, much of the interest in ESG issues was focused on corporate governance, which has long been factored into investment decisions, but there has been a shift toward thinking **more about environmental and social issues**.
- There has been a growing realization – particularly on a longer-term horizon – that **ES issues are material in terms of risk and opportunity**, as well as less understood, with *greater potential for investors to add value* through analysis.
- <u>Example</u>: BMO Global Asset Management believes **human capital**, and the recruitment and retention of talented staff, are **ever more important in long-term business performance**. Through the dedicated **reo**© engagement and voting service* run by our London-based GSI team, we engage regularly with companies about labour management strategies and global supply chain standards (e.g., Rana Plaza disaster in Bangladesh).

Moving Forward: A Sustainable Form of Capitalism

In the age of social media and "big data," individuals are more capable than ever of understanding how their choices impact on the wider world – and investment choices are no exception.

As ESG integration builds momentum, there is now a wider range of RI strategies available than ever before for institutional investors, made possible by growing confidence that the consideration of ESG issues is not only compatible with generating financial returns, but is also supportive of stable, long-term performance. Investors should understand that while RI funds may deviate from mainstream benchmarks in the short-term due to their orientation, our experience in the long term – from running these strategies over three decades – is that principles and performance can go hand in hand.

As one of the fastest growing asset managers worldwide, BMO Global Asset Management has a responsibility to loudly – and effectively – encourage proactive participation in the achievement of the UN's SDG, especially relevant in our world of heightened uncertainty. By consistently applying our ***Invest, Avoid, Improve*** philosophy (*see below*) and integrating ESG-related considerations within a wide range of our investment processes, we're helping to ensure that the global investment community is more transparent on ESG issues, promoting RI management as an essential part of working toward a more sustainable form of capitalism, and bringing meaningful change.

BMO GAM: Our Responsible Investment Philosophy

Invest

Invest in companies that make a positive contribution to society and the environment

Avoid

Avoid companies with damaging or unsustainable business practices

Improve

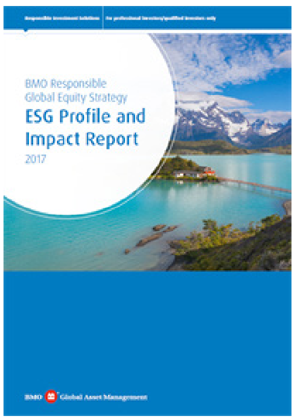
Use influence as an investor to encourage best practice management of ESG issues through engagement and voting

Stay tuned for Part 2 of *IQ's* ESG series, which will provide a closer look at BMO Global Asset Management's dedicated set of Responsible Investment solutions, engagement initiatives and how we integrate ESG issues within our mainstream investment analysis.

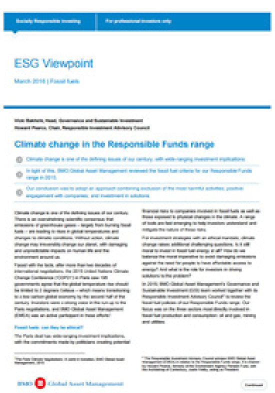
To learn more about our comprehensive RI Fund Range, click here, or access the materials below.

2016 Responsible Investment Annual Report

BMO Responsible Global Equity Strategy: ESG Profile and Impact Report 2017



ESG Viewpoint: Climate Change in the Responsible Funds Range



BMO Global Asset Management's Responsible Investment Solutions

[1] University of Oxford and Arabesque Partners, 2015.

[2] Natixis Research, February 2017.

[3] BMO Global Asset Management. As of December 31, 2016.

* The reo© engagement and voting service is not utilized by all legal entities of BMO Global Asset Management.

Not intended for distribution outside of Canada.

Certain of the products and services offered under the brand name BMO Global Asset Management are designed specifically for various categories of investors in a number of different countries and regions and may not be available to all investors. Products and services are only offered to such investors in those countries and regions in accordance with applicable laws and regulations.

The information provided herein does not constitute a solicitation of an offer to buy, or an offer to sell securities nor should the information be relied upon as investment advice. Any statement that necessarily depends on future events may be a forward-looking statement. Past performance is no guarantee of future results. Investments should be evaluated according to the individual's investment objectives. Professional advice should be obtained with respect to any circumstance. Prospective investors are advised to read the offering memorandum and to consult with an independent financial advisor prior to making any investment decision based on this document.

BMO Global Asset Management is a brand name that comprises BMO Asset Management Inc., BMO Investments Inc., BMO Asset Management Corp. and BMO's specialized investment management firms.