Phillips, Hager & North
Investment Management®

Investment Insights

Understanding ESG

Pension plans and endowments are increasingly considering environmental, social, and governance (ESG) factors as part of their investment policies. We also see clients developing statements that reflect their approach to responsible investing and including ESG considerations in their Statements of Investment Policies and Procedures (SIPPs). There are a number of forces driving these developments, including increased focus by plan members and other constituents as well as regulatory changes.

One such regulatory change will come into effect January 1, 2016, when Ontario pension plans will be required to state in their SIPPs whether ESG factors are incorporated into the plan's investment process, and if so, how they incorporate those factors. This will be new disclosure for most plans and might present a hurdle to some, as no definition of ESG has been given, nor has there been any guidance as to how ESG factors may or should be considered.

Within this changing environment, this paper is meant to give guidance to plans that are looking at integrating ESG into their SIPPs.

What is ESG?

ESG refers to environmental, social, and governance factors that may have a material impact on an investment. Examples from each category are listed below:

- ***Environmental:*** Environmental factors include the impact of a company's activities on the climate, including greenhouse gas emissions, and the risks and opportunities presented by climate change, energy efficiency, pollution, water and waste management, site rehabilitation, biodiversity, and habitat protection.
- ***Social:*** Social factors include human rights, community consent/impact, respect for indigenous peoples, employee relations and working conditions, discrimination, child labour and forced labour, health & safety, and consumer relations.
- ***Governance:*** Governance factors include the alignment of interests between executives and shareholders, executive compensation, board independence and composition, board accountability shareholders rights, transparency/disclosure, anti-corruption measures, financial policies, and the protection of private property rights.

ESG should be distinguished from socially responsible or ethical investing, which tends to use values-based judgements to screen out certain investments or sectors. In contrast, integrating ESG factors into the fundamental analysis of a company or security helps investors better understand the potential risks and opportunities of an investment. Considering these risks and opportunities should lead to enhanced portfolio performance over the longer term.

Why Is ESG Relevant?

ESG factors are relevant to virtually all asset classes, including equities, fixed income, private equity, real estate, and infrastructure. Although the potential impact of ESG factors may not reveal themselves in financial statements, they can impact the value of shares or debt as readily as more traditional financial factors. For example, if a mining company is facing opposition to a new mine from the local community, that opposition could result in the company losing its license to operate. As result, that community opposition represents a real financial risk that needs to be factored into the assessment of any potential equity or debt investment in the company. Similarly, if a sovereign debt issuer is politically unstable or prone to corruption, those risks are relevant to the risk or return of that debt and should likewise be considered.

Conversely, if a company is doing a good job of identifying and managing its ESG risks and opportunities, it may be better than its competitors at identifying and exploiting competitive advantages to deliver superior long-term, sustainable returns. In addition, when a company manages ESG risks well, it is often a good indication that it manages other risks well, which provides additional insight on the quality of management at the company.

How Will Changing Regulations Affect Pension Plans and Endowments?

To adapt to the changing regulatory environment surrounding ESG, plan trustees first need to understand how ESG factors may be relevant to each asset class in which the plan is invested.

Assuming that trustees conclude that ESG factors are relevant to at least some of their investments, they must then consider how best to incorporate ESG factors into the investment process. Developing a specific policy on ESG integration is a good first step, as this policy can then be referenced or incorporated into the SIPP. Plan trustees may want to develop this policy in consultation with their stakeholders, investment managers, and consultants. They can also look to their peers who may already have experience integrating ESG into their own investment process.

Plan trustees can also ask their investment managers how ESG is integrated into the portfolios managed for the plan, and may want to begin incorporating ESG criteria into their manager selection process. They can begin this process by asking potential investment managers about their approach to ESG, including:

- How do you incorporate ESG factors into your investment process?
- Do you engage with the companies in which you are invested, and if so, how?
- How do you manage your proxy voting?
- What kind of regular ESG-related reporting is available to your clients?

Plans may also want to consider incorporating ESG-related requirements into their managers' mandates.

In accordance with the new regulations coming into effect in Ontario, pension plans will have to disclose how ESG factors are incorporated into their investment process. The new regulations do not offer any guidance as to the level of detail required for that disclosure, so different plans will likely have different approaches. A plan's approach will likely depend, at least in part, on the extent of their experience with ESG integration. Adopting a specific ESG policy for the plan will certainly help guide this process.

How Can We Help?

Phillips, Hager & North Investment Management has already developed an approach to responsible investing and is systematically integrating ESG across all of its investment teams and asset classes. Our investment teams have access to industry-leading research on ESG issues and we have a team of experts facilitating our ESG integration, ESG-focused engagement, and proxy voting. As a founding member of the Canadian Coalition for Good Governance and as members of the Council of Institutional Investors, the International Corporate Governance Network, and the Responsible Investment Association, we have a long history of collaborating with other investors and we continue to broaden our involvement with other investor-led organizations. We will be providing an annual report of all of our ESG-related activities and can provide customized ESG reporting to our clients.

We would be pleased to provide any additional information that you require and explain how we can help as you consider the new regulations.

For additional details, please contact your PH&N IM institutional portfolio manager, or:
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