Responsible Investment

Improving the odds of better long-term outcomes

> **Why investors should care about Environmental, Social, and Governance (ESG) factors:**
>
> - ESG factors have become a cornerstone of corporate strategy
> - Regulatory pressure and scrutiny are rising significantly
> - ESG mandates now account for one-third of all assets under management worldwide, and growing
> - Consideration of non-financial factors can unearth critical success factors and risks

ESG factors: An emerging foundation stone of corporate strategy

Over the past couple of decades, ESG factors have become increasingly embedded in corporate strategy for two principal reasons. Firstly, CEOs and company management teams have come to realize that considering ESG factors was not merely a question of "doing good" but that it also made good business sense. Secondly, companies nowadays need to be perceived by their stakeholders as acting in a way that is fair, appropriate, and trustworthy.

Good business sense

ESG factors are those that can have a *material* influence on, or are *reasonably likely* to affect, the future financial performance of a company. While these factors have not leant themselves to traditional financial analysis, they nonetheless have become foundationally important to corporate strategy, particularly in response to external challenges—such as climate change, geopolitical realignments, and new social trends—which have increased rapidly in number, importance, and complexity.

A growing number of businesses report that taking into account ESG factors as part of an effort to foster sustainability materially improved:

- the ability to attract and retain skilled workers and management, as well as talent development;
- relationships with both customers and suppliers;
- regulatory standing; as well as
- access to, and cost of, capital.

In a February 2021 Global Insight article, Habib Subjally, head of RBC Global Asset Management's global equity team, observed that when a company's management team "has correctly identified employee engagement as one of its key success drivers, and intentionally works to build that engagement, to maximize and sustain its value in the operation of the business, then, the company can be thought of as accumulating an important 'contingent asset'—one that could quite conceivably be the most important asset it has, but one that is not recorded anywhere in the financial statements."

Such positive non-financial factors are likely to help a company build and maintain a sustainable competitive advantage, or staying power, and can lead to above-average returns for shareholders while simultaneously reducing or limiting risk.

For example, one of the keystones of Home Depot's corporate strategy is to prioritize strong labor practices to ensure employees are engaged. This provides the company with a competitive edge difficult to replicate.

Subjally also noted that "A company that has developed an understanding of the potential impact of climate change on its end markets, suppliers, employees, and facilities—and has a plan for dealing with it—is, in our view, a less risky investment than one which hasn't."

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Companies which ignore these ESG factors do so at their peril, in our opinion. Poor ESG practices can build an accumulated contingent liability that would not be captured by traditional financial analysis.

A prime example is the collapse in Brazil in November 2015 of two mining dams operated by Samarco Mineração SA, a joint venture between Vale and BHP. The disaster released 50 million cubic meters of toxic iron-ore residue, polluting the water supply of hundreds of thousands of residents and costing more than 250 lives. Senior executives are facing "qualified homicide charges" and the joint venture is paying out billions in compensation for disaster victims.

Like other corporate assets, contingent assets can be drawn on, and are a source of return and corporate staying power. Liabilities, contingent and otherwise, come due and payable (often at inopportune times) and can even capsize a business. Identifying both is an important method of adding value for investors.

Integrating ESG factors into corporate strategy also makes good business sense as it can help reduce companies' cost of capital.

Companies that pay attention to ESG factors tend to have access to cheaper debt and equity financing as lenders and investors perceive them as having lower risk exposure. Several studies confirm this, including one MSCI conducted from 2016 to 2019 on companies in the MSCI World Index which found that the top 20 percent of companies in terms of ESG factor quality had a measurably lower cost of capital than the bottom 20 percent. This, in itself, suggests that companies will try and improve their ESG scores, if only out of self-interest.

Under pressure

Corporate management teams have also been under pressure to take ESG factors into consideration from stakeholders. Companies need to ensure that the perceptions of stakeholders, be they consumers, employees, suppliers, investors, or regulators, are both favorable and durable over the long term. Just look at the long list of companies which pulled out of Russia in 2022 not wanting to be perceived as propping up the Russian government, or the more than 5,000 companies which have committed to science-based net-zero targets, at times doing so despite skeptical national governments.

It is difficult for a company to recover from an erosion of trust due to a tarnished reputation. Pacific Gas & Electric (PG&E), the American utility company, emerged from

ESG factors vary according to the industry

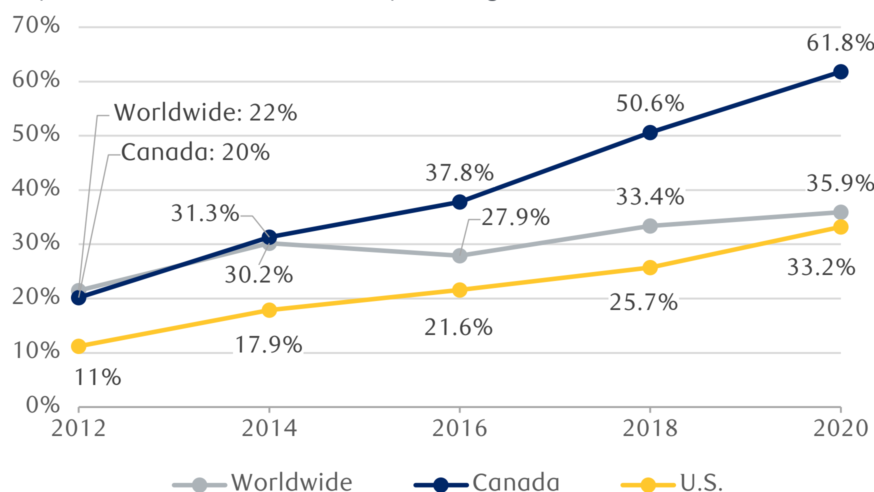
Examples of material factors for SASB industries

Industry	Sub-industry	Some ESG factors material to the sub-industry as per SASB
Consumer Goods	Apparel, Accessories, & Footwear	• Materials sourcing & efficiency • Product quality & safety
Extractives & Minerals Processing	Oil & Gas	• Employee health & safety • Critical incident risk management
Financials	Insurance	• Selling practices & product labeling • Systemic risk management
Food & Beverage	Processed Foods	• Materials sourcing & efficiency • Product design & lifecycle management
Health Care	Drug Retailers	• Data security • Customer welfare
Infrastructure	Electric Utilities & Power Generators	• Access & affordability • Business model resilience
Renewable Resources & Alternative Energy	Wind Technology & Project Developers	• Employee health & safety • Materials sourcing & efficiency
Resource Transformation	Chemicals	• Waste & hazardous material management • Employee health & safety
Services	Hotels & Lodging	• Labor practices • Ecological impacts
Technology & Communications	Telecommunication Services	• Customer privacy • Competitive behavior
Transportation	Automobiles	• Product quality & safety • Materials sourcing & efficiency

Source - Sustainability Accounting Standards Board (SASB)

RI assets have grown in importance

Responsible Investment assets as a percentage of total AUM



Source - Global Sustainable Investment Review 2020 (GSIR)

bankruptcy in 2020, but its reputation doesn't seem to have recovered. Its exposure to wildfire risks that drove it into bankruptcy in the first place continues to cause concern.

Moreover, companies cannot wait for regulators to tell them what to do. Consumers and clients have increasingly high expectations, wanting sustainable products available and sustainability challenges addressed. A study performed by EY in 2021 found that as many as 69 percent of Canadian consumers expect companies to solve sustainability issues. A 2021 Deloitte study revealed a similar percentage of U.S. consumers (65 percent) believe CEOs should do more to make progress on issues such as reducing carbon emissions, limiting air pollution, and making business supply chains more sustainable.

Unsurprisingly, many companies want to be perceived as being ahead of the curve on ESG matters. While CEOs recognize that taking into account ESG factors makes good business sense, pressure from stakeholders should ensure that incorporating ESG factors into corporate decision-making is here to stay.

Increased regulatory oversight

Regulatory oversight of ESG disclosure standards is increasing. The Sustainability Accounting Standards Board (SASB), the body which developed a set of industry-specific standards for corporate reporting on ESG issues, is being rolled into the realm of both the SEC and the International Financial Reporting Standards Foundation (IFRS Foundation), the organization which develops the accounting standards used in most jurisdictions.

The SASB developed standards for corporate reporting on ESG issues over a five-year research effort involving the participation of some 3,000 business executives, academics, analysts, and regulators. Participants came to a consensus as to what ESG factors could be considered *material*, i.e., could come to bear on a company's financials according to the industry in which it operates.

Into the mainstream

Assets managed according to Responsible Investment precepts have experienced faster-than-average growth, and now make up more than one-third of assets under management (AUM) worldwide. Bloomberg Intelligence estimates global RI assets are on track to exceed $50 trillion by 2025, up from $22.8 trillion in 2016, assuming conservatively that growth rates going forward are half those experienced in the past. RI assets could well represent some 50 percent of all AUM by the end of the decade.

This growth has been driven by the increasing popularity of ESG strategies among investors as well as by institutional investors whose fiduciary responsibilities encourage them to include ESG factors as part of their analysis.

Most institutional investors have a fiduciary obligation to act in the best interest of the people whose money they manage. They are responsible for taking into account all material information in the execution of their duties, including any information which could affect financial performance.

For institutional investors, ESG factors have become an important component of investment decision-making. In an RBC Global Asset Management survey conducted in 2021 of more than 800 institutional investors worldwide, 57 percent of respondents selected "fiduciary duty" as their main reason for adopting ESG factors, while 52 percent cited "risk-adjusted returns."

In fact, so convinced are investment managers that ESG considerations are a part of their fiduciary duty that the Principles for Responsible Investment, a United Nations-backed international network of investors, now has more than 3,800 signatories managing over $120 trillion in assets, up from some 60 signatories managing $6.5 trillion 15 years ago.

Clearly, the capital committed to incorporating ESG factors into financial decisions is large and growing.

Still skeptical?

Skepticism regarding ESG analysis is understandable. But that doesn't mean one should throw the baby out with the bathwater. To us, the points of contention indicate growing pains around the acceptance of ESG factor analysis rather than inherent flaws in the methodology. We think the critics are missing the mark on several points:

- *"There are so many different ESG measurements, it's too confusing."*

  There is indeed a wide range of, at times, conflicting scoring, and varying ESG metrics. For instance, some companies use training hours to assess investments in their labor forces, while others use training costs as the measuring stick. Yet these differences in and of themselves do not mean that ESG factors should be ignored altogether. We believe measurement methods are likely to evolve and improve over time, much as financial reporting did. In fact, some differences in accounting rules remain—the generally accepted accounting principles, or GAAP, used in the U.S. still differ from the IFRS standards used globally. But that doesn't mean either lacks rigor.

- *"There is widespread evidence of greenwashing."*

  Yes, some companies or funds do overstate their ESG credentials so as to make an investment seem more sustainable than is actually the case. And that is why regulators are cracking down on offenders. The SEC in particular is actively investigating false claims and pushing for more standardized disclosure.

- *"With the fallout from Russia's invasion of Ukraine, resolving the food and energy crises means ESG considerations are taking a back seat, particularly with regards to climate change."*

  While the short-term focus of some companies is justifiably on the food and energy crises, long-term efforts to enhance sustainability are proceeding on another track, as shown by U.S. President Joe Biden's recent signing of the Inflation Reduction Act into law, which promotes clean energy solutions.

Here to stay

ESG factors have become a pillar of corporate strategy. Taking them into consideration is widely seen by management teams as making good business sense. The need for a corporation to be perceived in a favorable and durable way over the long term by their stakeholders should ensure that considering ESG factors in corporate strategy is here to stay.

This should be facilitated by increasing regulatory oversight which, in turn, should effect greater transparency and produce more meaningful ESG data. With ESG assets representing an increasingly large portion of all assets under management, we believe investors can no longer afford to overlook non-financial data.

RBC Wealth Management has developed proprietary tools designed to bring the consideration of ESG factors into the investment process in a way that we believe can improve the odds of better long-term financial outcomes.

For more information on how this framework can help you meet your objectives, financial and otherwise, please consult your investment advisor.

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