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'Ethical' investors embrace a new yardstick

By GUY DIXON

Experts recommend investing in the best-behaved firms, even in troublesome sectors

Michael Jantzi remembers a simpler time.

In the early 1990s, some ethical investment funds would screen out the worst transgressors, such as the heaviest polluting companies. Others would focus less on screening out – and instead on investing in – shares in more ethically conscious businesses. But the concept was simple, and ordinary investors felt like they were taking positive, direct action.

"This was a field that was fairly black and white," said Mr. Jantzi, the Toronto-based chief executive of the global research firm Sustainalytics¹, which analyzes the environmental and social performance of companies. Yet exclusionary ethical investing was "a philosophy that never resonated with me," he said.

It was too cut and dried, he felt. Instead, he and his firm, which started as Jantzi Research in 1992 and merged with Europe-based Sustainalytics in 2009, have been part of a new approach taking hold.

Instead of analyzing which companies or whole industries to screen out, the idea is to compare and rank companies within those industries. Sustainalytics analyzes which have done better on a variety of environmental, social and governance (ESG) issues.

"We do not expect perfection from companies. We are going to compare them, one to another," Mr. Jantzi said.

For instance, Sustainalytics provided an October, 2014, report on Bombardier Inc., the Montreal-based aerospace and transportation giant. Despite its recent management troubles, the company's ESG scores are good, the second highest among peers of its size.

The report grades Bombardier on the intensity of its carbon emissions, its employee diversity programs, its whistleblower programs and whether it has faced recent environmental fines, among other factors. The company scored highly on its environmental policy; the report notes, for instance, that the company has launched renewable-energy initiatives, but added that it's unclear how committed the company is to using renewable energy more prominently.

Sustainalytics' goal is to figure out whether a firm will be crippled by its poor social or environmental record or will outperform in those areas and earn more business because of it.

But is this best-of-sector analysis good enough? Will some investors instead see it as picking "the least worst," and not a path to halting poor environmental or social behaviour?

The best-of-sector approach is acceptable only "if there's a zero target after X number of years," said Cedric Dawkins, associate professor and a specialist in business ethics at Dalhousie University's Rowe School of Business. There should be a clear goal of stopping the transgression in a specified period of time, he says, "otherwise, you're just being co-opted into waiting," and not eliminating the problem, he said.

So, what can be done? The problem is that a small number of ethical investors sticking to their conscience really don't have much of an impact, argued Andrew Crane, professor of business ethics and director of the Centre of Excellence in Responsible Business at York University's Schulich School of Business in Toronto.

"If you want to improve the environmental performance of energy companies, for example, not investing in them doesn't give you a voice. [It] doesn't give you any way of engaging with them," he said.

"Whereas if you are rating them against each other, and then investing in the ones that do best, you're providing a clear signal that if you improve your performance, then you'll get more attention from investors."

Also, the strategy of divesting from offending firms doesn't always work. Not buying oil stocks isn't necessarily a complete divestiture, Dr. Cane noted. If you own bank stocks, those banks will likely be invested in oil companies.

Ranking companies "has really come about as a way of trying to have the most effect on business, rather than simply being a way for individual investors to have a clean conscience," he said.

At the same time, social concerns have become more mainstream. Investing ethically isn't a fringe strategy. Environmental and social issues are risks that all companies must address, many say.

"Today, the mainstream understands that if you're operating an oil and gas company, you have to understand ramifications of climate change and carbon. You have to understand water issues. You have to understand human-rights issues. It's no longer just issues that are in the domain of government or civil society," Mr. Jantzi said.

Plus, it's not easy for investors in Canadian investment funds to exclude the resource sectors, which are so central to Canada's economy.

Jason Milne, manager of corporate governance and responsible investment at Royal Bank of Canada Global Asset Management, said that by taking a best-of-sector approach with its sustainability funds, "we're not excluding whole sectors. So even though some investors have concerns about fossil fuels, we're not excluding all fossil fuel companies. We're eliminating the ones that perform poorly on ESG factors."

But do ethics come at a price? Are investment returns lower?

They can be in the short term, over a year or two, Mr. Milne said, since the exclusion of some companies means fewer investment options.

Many studies have found, however, that this situation improves quickly over the mid to long term. Why? One reason is that the number of securities typically screened out isn't large, noted a Royal Bank of Canada report in 2012 on socially responsible investing.

In fact, ethical funds sometimes outperform the overall market because they include companies that are simply better managed all around, said Sarah Kaplan, associate professor at the Rotman School of Management at the University of Toronto.

"When you look at companies that are good on gender, or good on environment, or good on governance, these are probably overall just better companies," Ms. Kaplan said.

The thinking now is that investing according to ESG doesn't get in the way of investment-return performance, she says, "and may even lead to outperformance."

Embracing ethical investing

Ethical investment is on the rise, according to a report issued by the trade group Responsible Investment Association and Royal Bank of Canada.

- **\$1.01-trillion:** Canadian assets under management using responsible investing strategies at the end of 2013, up from \$600-billion at the end of 2011

- **31 per cent:** Portion of invested assets under management in Canada that involve some aspect of responsible investment
- **41:** Number of investment management firms reporting Canadian responsible-investing assets, compared with 24 at the start of 2012

References

1. www.sustainalytics.com

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