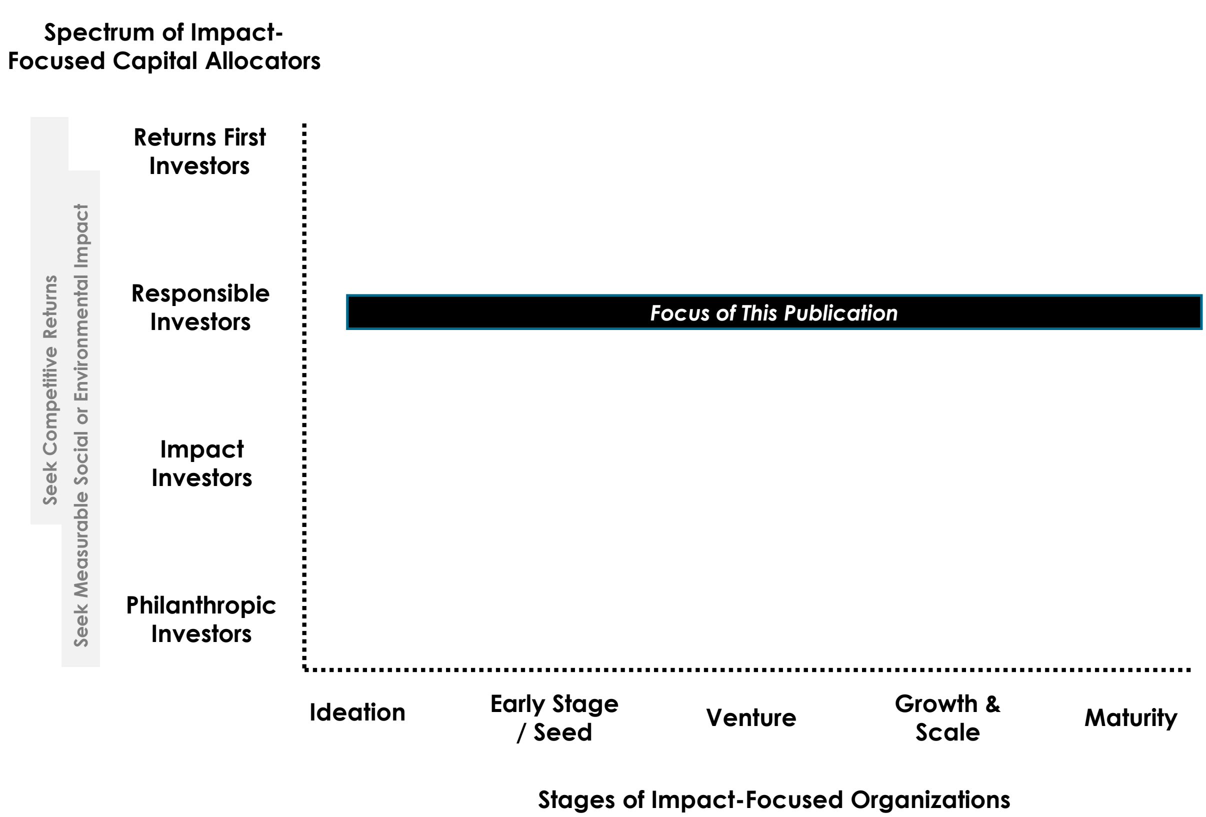
THOUGHT

Responsible Investing for Dummies & Experts

"Every sustainable finance buzzword you've ever heard - responsible investing, ESG, SRI – means something different to everyone you talk to. Some investors still need education and clarity on what responsible investing even is…others are still trying to understand what the various responsible investment options are…and even the most experienced responsible investors are trying to figure out what is next"

– an anonymous ***Responsible*** *investor*

Businesses, customers & investors are all over ESG. Integrating ESG into business practices, investment due diligence and governance is in full force. Despite the rapid growth in interest and investment we have all witnessed, we are still in the early days of the responsible investing industry. This paper focuses on level-setting the reader on the lay of the land in responsible investing, what the industry gaps & opportunities are, and what specific niches within the ESG investment may be well worth digging into.



Let's start with definitions
Responsible Investors avoid irresponsible companies and/or seek companies that actively integrate responsible business practices

Responsible Investing (RI) refers to the incorporation of environmental, social and governance factors (ESG) into the selection and management of investments. (Source: Responsible Investment Association). Responsible investment's primary focus is into enhance traditional financial analysis, by identifying the potential risks that may occur as a result of companies who are irresponsible in their business practices.

Socially Responsible Investing (SRI) goes one step further by actively analyzing ESG factors to eliminate or select investments to align an investors' values (Appendix 1)

The ESG movement is in full force - investors and companies are taking it seriously
RI and SRI strategies are growing in popularity. Investors are actively seeking opportunity to allocate capital to investment opportunities that consider social or environmental impact. They are supporting companies who do so with their own dollars

- Rapid growth in North American assets under management (AUM) using at least some form of responsible or impact investment strategy (Appendix 2)
- These trends are driven by a $31 Trillion intergenerational wealth transfer by baby boomers, to their millennial heirs. These heirs are actively seeking to support social and environmental investments (Appendix 2)
- Industry experts are starting to see correlations between margin performance and strong performance on environmental, social & governance (ESG) factors, as well as a rise in valuation premiums for companies within ESG topics as well (Appendix 3). When companies take ESG seriously, they are starting to see financial benefit, since customers are supporting these businesses with their investments and their spending.

What is next for experts who already know this?
RI and SRI strategies are changing at the same rate as the investment in-flows – rapidly. With years of evolution ahead, there are three ways investors can stay ahead

- **Focus on shaping RI/SRI investment infrastructure by understand its limitations**
  The limitations of RI and SRI strategies are becoming clearer. ESG factors are not a sufficient proxy for total social impact and many components of traditional investment infrastructure are lacking. The industry is evolving and responding to these limitations - capital allocators need become thought/policy leaders, attract and educate scarce ESG investment talent, and focus on their investment process (Appendix 4)
- **Be an <u>active</u> ESG investor – shaping the strategy and reporting cadence of your portfolio companies will create an investment edge.**
  Given the benefits companies are starting to see, company executives need to become acutely aware of how other companies are explicitly pushing their ESG strategies farther and father (Appendix 5), while accounting-like standards that are being built for ESG & impact reporting can't be ignored (Appendix 6) – active investors have an opportunity to closely work with and help push their portfolio investments benefit from a robust ESG strategy and reporting cadence
- **Carving the ESG landscape into smaller niches presents investors with better opportunities**
  For example in Canada, impact-focused assets are predominantly residing in public markets, with a limited number of attractive public ESG companies (Appendix 7). Growth equity and private equity investors should take heed of this demand and resulting scarcity value, to focus on helping scale companies with strong ESG-centric strategies and helping position them to be IPO-ready

Appendix 1

Understanding definitions is critical to remove the myths and perceptions associated with impact investing

Responsible Investors avoid irresponsible companies and/or seek companies that actively integrate responsible business practices

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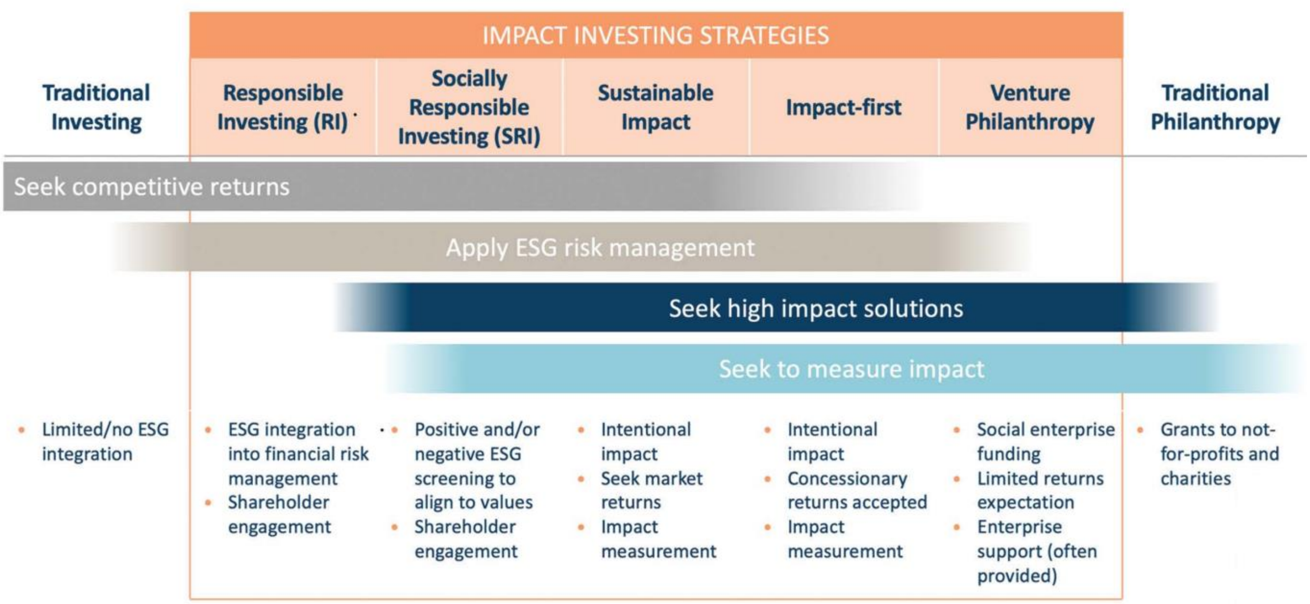
Using the investment spectrum from [Rally Assets Impact Investing Guidebook]provides further visual context about the differences between responsible investment strategies and other impact-focused strategies



A full primer on the impact investing landscape is well worth the read. Rally's guidebook is linked above for people looking for a deep dive.

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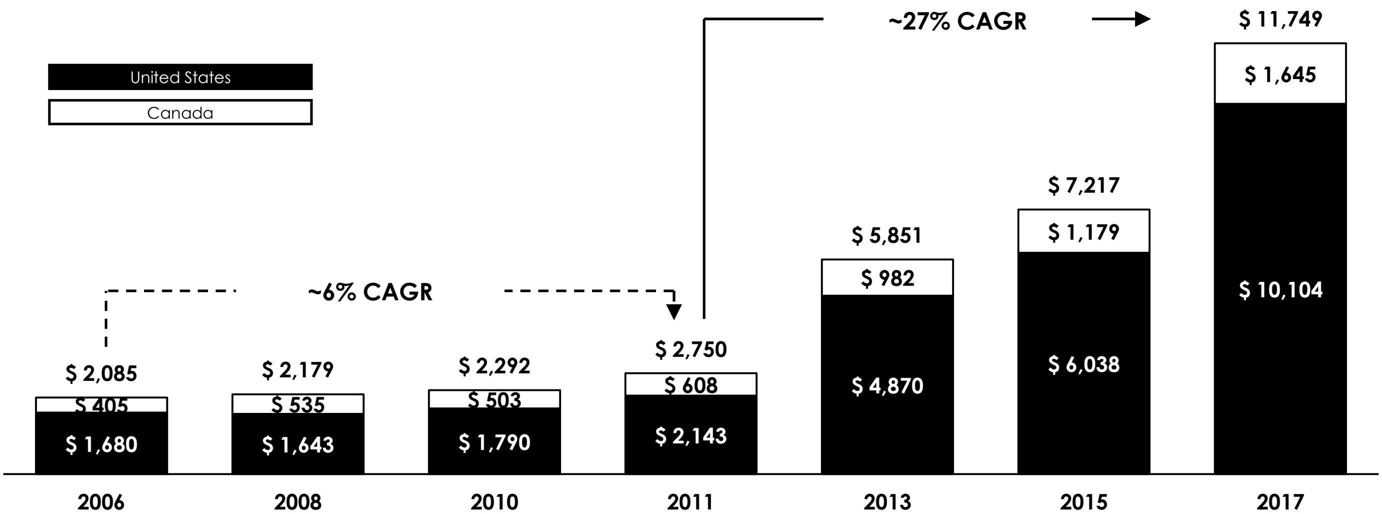
Rapid growth in North American assets under management (AUM) using at least some form of responsible or impact investment strategy
(US$ in billions)



Source: Responsible Investment Association; 2018 Canadian Responsible Investment Trends Report, US|SIF, *Report on US Sustainable, Responsible and Impact Investing Trends 2018*

Key statistics on the largest intergenerational wealth transfer in North American history

- In Canada - According to Strategic Insights, between now and 2026, an estimated $1 trillion of wealth will be transferred from baby boomers to their heirs (millennials)

  Source: *Strategic Insights*

- In North America – According to over $31 Trillion in assets will pass from baby boomers to their heirs over the next 30 years

  Source: *Strategic Insights*

- The majority of the shift will come from affluent baby boomers, directly to affluent millennials (depicted on the following page)

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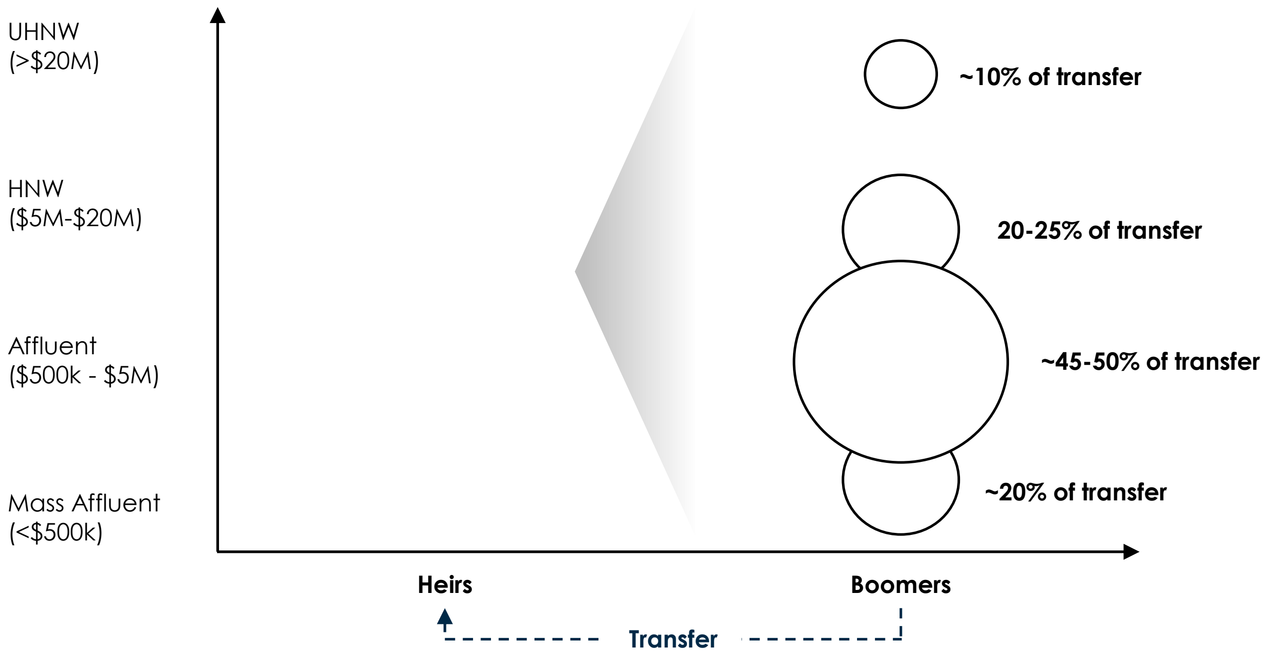
Key statistics on the largest intergenerational wealth transfer in North American history

- The majority of the shift will come from affluent baby boomers, directly to affluent millennials

Expected asset transfer from Boomers to Heir by major affluence cohort
(% of wealth transfer)

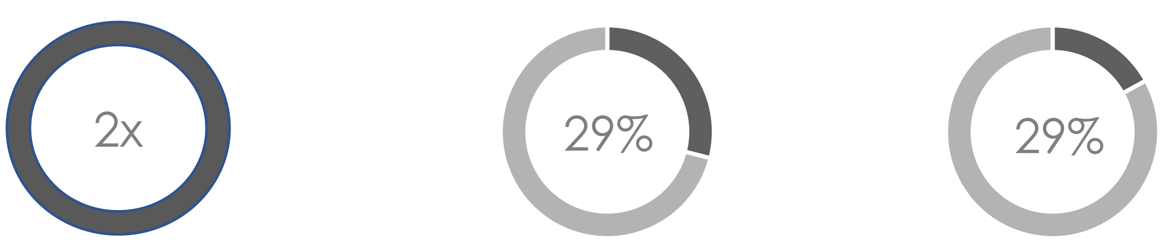


Source: Accenture, The "Greater" Wealth Transfer (for transfer distribution applied to Canadian $1 trillion transfer), Wealth Engine data and Coldwell Banker data (for transfer distribution applied to North American $31 trillion transfer)

- When assets change generations, asset managers typically lose 70% to 80% of those assets

Source: EY – Sustainable Investing: the millennial investor

Key statistics on millennial sentiment and predisposition towards investing for both financial and social returns



Millennials are 2x more likely to factor in sustainable investing criterion in their investments than baby boomers

of investors in their 20s and 30s seek a financial advisor that provides values-based investing. Millennials rank this priority third in a list of nine identified priorities

17% of millennials indicate they seek to invest in companies that use high quality ESG practices, compared with 9% of non-millennial investors

Appendix 3

Margin premiums are linked to strong performance in ESG topics – companies who perform well in ESG topics are earning better industry margins than their industry peers who aren't

Consumer Packaged Goods

Conserving Water
3.1 pp EBITDA
5.5 pp Gross profit

Ensuring a responsible environmental footprint
1.3 pp EBITDA
3.3 pp Gross margin

Limiting negative effects on biodiversity and ecology
3.0 pp EBITDA

Minimizing impact of products and packaging
4.1 pp EBITDA
12.4 pp Gross margin

Socially responsible sourcing
4.8 Gross margin

Biopharmaceuticals

Conducting ethical human clinical trials
6.1 pp EBITDA
6.3 pp Gross margin

Expanding access to drugs
8.2 pp EBITDA
6.7 pp Gross margin

Promoting transparent lobbying
5.1 pp EBITDA

Oil and Gas

Maintaining process-oriented health and safety programs
3.4 pp EBITDA

Supporting ongoing employee training
8.2 pp EBITDA
6.3 pp Gross margin

Retail and Business Banking

Avoiding and combating corruption
2.3 pp Net income margin

Ensuring fair debt collection
0.5 pp Net income margin

Ensuring fair selling practices
0.4 pp Net income margin

Environmentally responsible sourcing
3.4 pp Net income margin

Promoting financial inclusion
0.5 pp Net income margin

Source: Boston Consulting Group, Total Societal Impact (2017)

Higher valuations are linked to strong performance in certain ESG topics

Consumer Packaged Goods	Biopharmaceuticals	Oil and Gas	Retail and Business Banking
11% Valuation Premiums	**12%** Valuation Premiums	**19%** Valuation Premiums	**3%** Valuation Premiums

Source: Boston Consulting Group, Total Societal Impact (2017)

Takeaway
Industry experts are starting to see correlations between businesses' margins and valuations and their performance on certain ESG topics, relative to their peers. For us, tracking the progress of margins & valuations of these impact-focused companies is critical to the sustainability of this industry in the long term, and the early signs are promising

Appendix 4

ESG has its limitations & its risks

Capital market's participants largely use ESG to evaluate corporate social responsibility; we believe that people confuse the adherence to ESG standards as an appropriate proxy for social impact.

- Subjectivity
  There are largely no official criterion leaving investors to define their own values

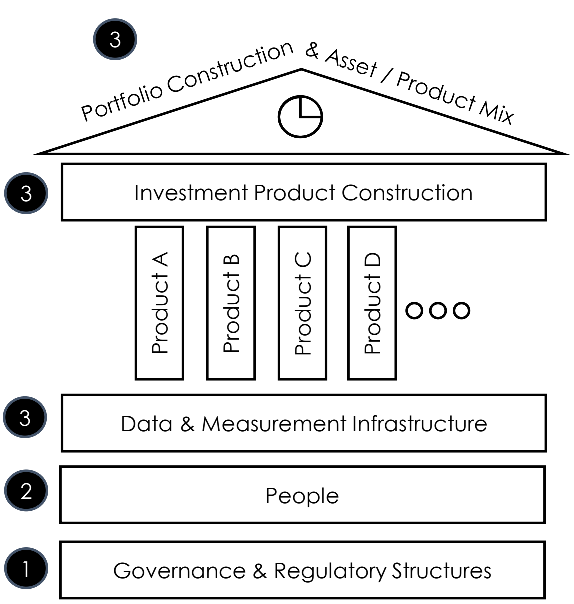
- Scope
  ESG criteria establish if a business is responsible so that investors avoid the risk of terrible losses as a result of a lack of ESG practices (e.g, oil spills, emissions scandals) – the E, S, and G are critical pieces of corporate social responsibility, but responsibility is not impact, and it's important to not confuse the two, but often-times investors do. This is particular important to ensure the purpose of your capital is aligned with the mandate of the investment strategy you're using

- Data Standardization
  As we have previously referenced, 85% of companies in the S&P500 published a sustainability report, up from just 20% in 2011, showing the dramatic growth in volume of ESG data available. However, a quick look at this data reveals an important issue: the ESG reported by companies is not standardized and often to complex. This makes it extremely difficult to compare / benchmark company ESG impacts with one another. Though there are organizations aiming to solve this problem, there is currently no trivial solution. For more information on this, please reference Seeking Return on ESG by the World Economic Forum

- Availability beyond public equities
  Availability of ESG data on assets / businesses becomes significantly worse outside of public equities, creating further obstacles for asset managers looking to expand ESG investing into other asset classes. The Boston Consulting Group concluded that this thus creates further obstacles for investors who are looking for sustainable investing strategies in asset classes that include fixed income, real estate, and commodities

- Greenwashing
  Greenwashing is the process of falsely conveying to stakeholders that a given product, service or company factors environmental responsibility into tis offerings and operations. The growth and popularity of ESG investing has increased the incidence and potential risks of greenwashing

Asset managers can actively get ahead of how these limitations will change the industry



1 **Get ahead on reporting standards**
Companies and independent authorities will help establish accounting-like standards for social return measurement and reporting, akin to IFRS, and they will be changing rapidly.

2 **Talent is scarce, internal education is a must**
Building more investment and research talent that is specifically skilled / trained in the social investment landscape is becoming a must

3 **Get ahead on investment process**
The evolution of data, social and environmental return measurement, and the investment product suite are all in their early days

Appendix 5

For illustrative purposes, understanding a few case studies of the degree to which companies are pushing their ESG strategies can give investors and company executives insight on how far ESG strategies are being taken, and the level of self-reporting companies are doing about these initiatives.

Key Takeaway
Company executives are already overburdened. Investors and capital allocators have an opportunity to support their portfolio companies by designing creative, more comprehensive and transparent strategies and actively help with ESG integration.

Gap

Description

Gap, Inc. operates as a global apparel retail company. It offers apparel, accessories, and personal care products for men, women and children

ESG Strategy[2]

"Each stage, from the first design sketches to end of life, presents opportunities and risks for our business, the environment and everyone who is touched by our brands."

Gap focuses on ESG initiatives throughout their entire value chain: design & development, raw materials & processing, manufacturing, product finishing, distribution, retail, and end of life. They measure their initiatives against three broad impact areas: Social, environment, and product sustainability.

For more information, visit https://www.gapincsustainability.com/

EQUINIX

Description

Equinix, Inc. is an American multinational company headquartered in Redwood City, California, that specializes in Internet connection and data centers. The company leads in global colocation data center market share, with 200 data centers in 24 countries on five continents.

ESG Strategy[2]

Equinix's ESG program is comprised of four pillars: Environment, Social, Governance, and Community that each align with our core purpose to connect, protect and power the digital economy.

Environment is focused on designing, building and operating data centers to minimize carbon and environmental footprint.

For more information, visit https://www.equinix.com/company/sustainability/

Appendix 6

The Takeaway:
Reporting standards and accreditations have the power to shift how investors and company executives consider their reporting and communications function, how they interact / report to stock exchanges, and the degree of their supply chain and operating model they have to share with the public to receive accreditation or be rewarded by consumers for their ESG strategies

We again find it illustrative to look at just a few case studies of how reporting standards and accreditations are changing and influencing how both companies and investors are being asked to behave

London Stock Exchange making strides towards regulated ESG reporting

EU law requires large companies to disclose certain information on the way they operate and manage social and environmental challenges. These rules apply to all publicly listed companies with over 500 employees, banks, insurance companies and other public interest companies.

These companies are mandated to disclose policies related to environmental protection, social responsibility, diversity on boards and other social issues.

For more information, visit this link.

In relation to the EU law, The United Kingdom public markets (specifically the London Stock Exchange) is making large strides towards strong and standardized ESG reporting.

In a report published by the London Stock Exchange, the organization outlines many relevant frameworks regarding ESG standards, including strategic rational, investor materiality and most important, how to create Investment Grade ESG data

For more information, visit this link.

The UK and the London Stock Exchange serve as a great example of a governing body creating rigor for ESG reporting.

Source: European Commission Non-Financial Reporting, London Stock Exchange – Your guide to ESG reporting

Social Value UK – an authority in SROI – is pioneering accreditation

Social Value UK is the British national network for anyone interested in social value and social impact. More specifically, Social Value UK facilitates a network for 700 global members and strives to create a standardized and consistent quantitative approach defining impact.

For more information on Social Value UK, please visit the following links:

Social UK's Guide to Social Return on Investment

Social UK's Assurance and Accreditation System

Social UK's Social Value Certification

Source: Social Value UK website

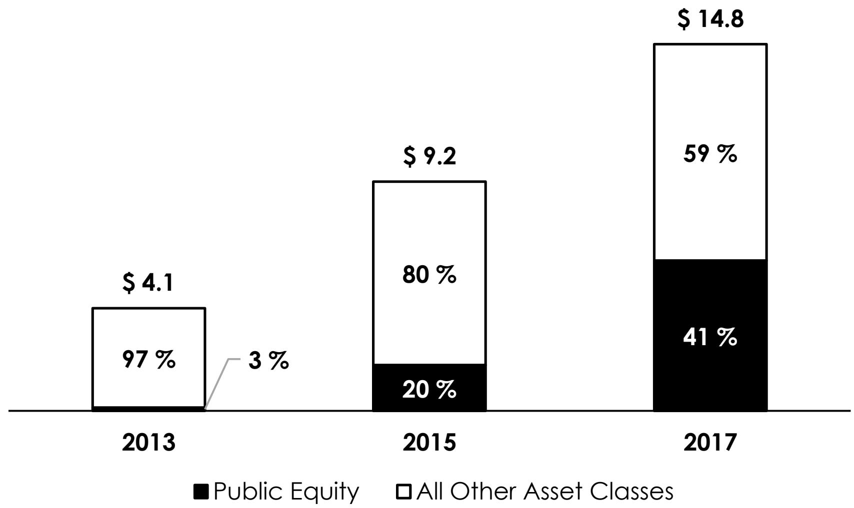
Appendix 7

A Case Study: In Canada, there is an over-indexing of new asset flows focused on public equity , despite a limited pipeline of attractive investment opportunities.

Public equity represents 41% of total Impact Investment assets, having grown from just 3% in 2013 (Figure)

We found the growth in public equity assets of interest, but unsurprising. In addition to the natural growing demand based on everything we have written thus far

Figure: Public Equity as a % of Impact Investing AuM
(C$ in billions)



Source: RIA Canadian Impact Investment Trends Report, Responsible Investment Association

We find it highly unlikely that the supply / growth of high-quality public companies exists to match the demand / growth in public assets being managed for impact. Consider the following Thought process:

- The universe of Canadian public investment opportunities has been shrinking rapidly – corporate listings on the TSX have declined 30% since 2008.
- According to the RIA there is $2.13T in assets under management in Canada that technically count as "responsible investments" – this is approximately 50% of total investible AUM
- Canadian stock markets are largely dominated by resource sectors, leaving a relatively small universe of non-resource companies available for investment (RIA: Impact Investment Trends 2018)
- If you seek to apply a disciplined investment process that rigorously filters quality companies, the true investible universe becomes even further limited – we have dealt with this challenge in a very real way, given the past experience in public equity analysis of our Founders
- While more companies are reporting on ESG factors, and companies that are qualifying as investments are continuing to grow, our own experiences in Canadian public equity analysis suggests there are not enough responsible investments that would provide a market return to investors
- This could be relevant to both public investors (who need to up their due diligence processes to unearth sufficient investor returns) and private investors (who could benefit from scaling companies to IPO)

The Takeaway
Carving the ESG landscape into smaller niches presents investors with gaps and potential opportunities. Growth equity and private equity investors should take heed of this demand and scarcity value to focus on helping scale companies with strong ESG-centric strategies and helping position them to be IPO-ready