Investing Responsibly with ETFs

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According to the 2020 Canadian Responsible Investment (RI) Trends Report from RiA Canada, at the end of December 2019 there were $3.2 trillion in RI assets under management, an increase of 48% over a two-year period. Over that same time period, RI mutual fund AUM in Canada increased 36% while RI Exchange Traded Funds (ETFs) AUM more than doubled. It's no coincidence that ETFs and RI are growing together because ETFs are cost-efficient delivery vehicles for RI strategies with several advantages over active RI solutions, especially for the Family Offices and Investment Counselling firms, who face scalability challenges.

Why is RI growing in Canada?

Historically, RI excluded companies and sectors having adverse social or environmental impacts. Today we understand that this subset of RI, Ethical Investing, may be narrow and have unintended consequences. Excluding companies and sectors means you have no voice at the table to push for change through engagement and Proxy voting. It also leads to tracking error, increasing the risk of not meeting required rates of return. There's also a growing acceptance that companies face non balance sheet liabilities that need to be identified and taken into consideration in the investment valuation process. As such, the world has moved away from an idealistic RI format to embrace ESG (Environment, Social & Governance) perspective. Fortunately, index based ESG solutions are cost effective ways to screen companies for hidden liabilities and invest in a cleaner broad index.

What issues need to be considered when implementing ESG?

ESG is an abstract concept that you're applying to an explicit outcome of meeting a required rate of return and you'll want to ask yourself how comfortable you are with tracking error. Constraints may introduce unintended TE and compromise your ability to meet a required rate of return. There's a fine balance between the desire to cleanse capital and the necessity to meet fiduciary obligations and, from a legal perspective, the former can't sacrifice the latter.

It's also important to understand that while there are many organizations trying to standardize ESG measures, there are many standards, so really there are none. The lack of standards may be confusing, discouraging even the most enthusiastic efforts to achieve consensus between you as fiduciary and other stakeholders or family members.

Finally, addressing diverse positions is critical. If you don't have consensus on key issues like the definitions and objectives of your ESG approach, you cannot make progress towards integrating ESG into the investment process.

For example, last year the Harvard Faculty of Arts and Sciences overwhelmingly voted that the $41bln Harvard Endowment Fund stop fossil fuel investments. While this vote was symbolic and didn't require the Endowment Fund to act, it shows how pressure from a group of non-fiduciary stakeholders can be applied to fiduciaries when rhetoric trumps consensus.

What are the merits of an index based ESG solution?

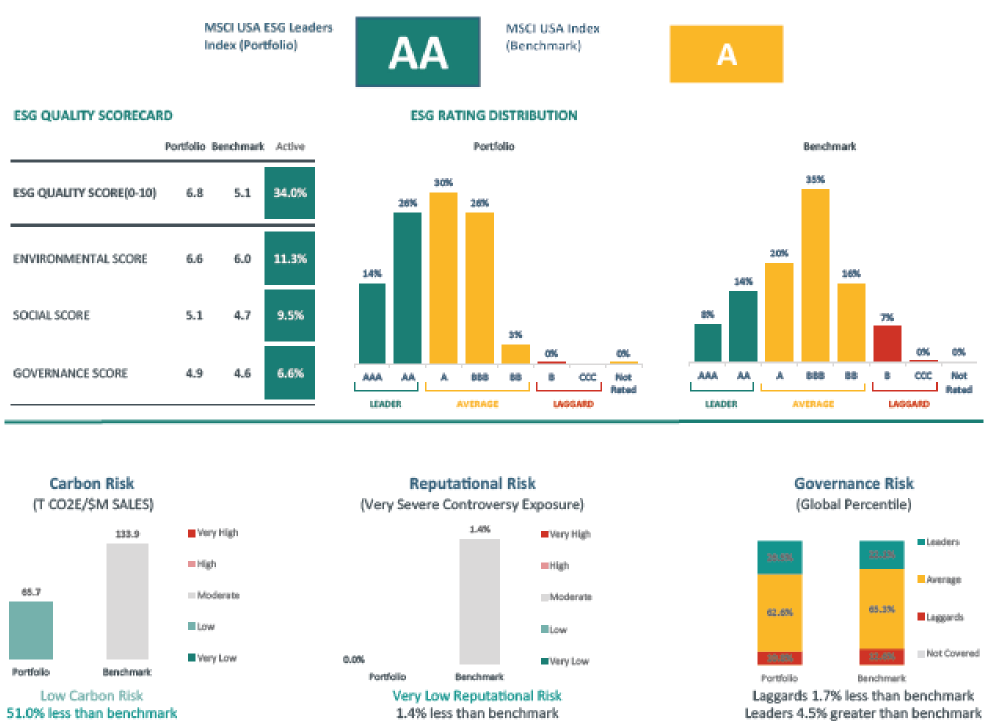
The rules of an index are transparent and have exclusions like alcohol, tobacco, firearms, and unconventional oil and gas, that will appeal to individuals with the strongest opinions. Knowing the rules makes it easier to seek consensus, you can ask important questions up front, "are we comfortable with these rules to cleanse are capital?" and "what, if any, compromises are going to have to be made to achieve our objectives or are there any unintended consequences in our approach?".

In a well constructed ESG Index, there is less tracking error. For fiduciaries the legal peril of missing required rates of return is significant. As a recent McCarthy Tetrault article discussed, incorporating exclusionary polices which may have an adverse impact on returns should be codified in a revised Investment Policy Statement to create allowances for Fiduciaries: https://www.mccarthy.ca/en/insights/articles/pension-fund-investment-managing-environmental-social-and-governance-esg-factor-integration). A good ESG Index like the MSCI ESG Leaders minimizes tracking error and thus reduces the risk of missing your required rates of return.

Index-based strategies have universal application. If you hire multiple active managers to execute your RI strategy in Canada, the US and globally, you will end up with a patchwork of RI solutions with no consistency in the implementation process. Index-based RI strategies are uniform across all geographies and market capitalization and ensure consistent implementations across all mandates. For many Investment Counsellors, Portfolio Managers, and family offices capacity and scalability are primary issues, the universality of index-based strategies will eliminate this problem.

Index based strategies are easily measured and monitored. Having transparent rules means that ESG performance can be evaluated at both the "company" and "portfolio" level helping you answer important questions like "how much lower is the carbon footprint of our strategy vs the benchmark?". Also, being able to easily measure and monitor the ESG performance means you minimize the likelihood of any ESG surprises and accusations of "greenwashing". Here's a sample ESG report card that we send to clients demonstrating the difference between ESGY – the BMO MSCI USA ESG Leaders Index ETF, https://www.bmo.com/gam/ca/advisor/products/etfs?fundUrl=/fundProfile/ESGY#fundUrl=%2FfundProfile%2FESGY, and the MSCI USA Index:

MSCI USA ESG Leaders Index



Risk Metrics

	Beta	Tracking Error	Turnover (%)	Standard Deviation (%, 10 Year)	Sharpe Ratio (10 year)
MSCI USA ESG Leaders Index (CAD$)	0.96	1.74	8.30	10.62	1.39
MSCI USA Index (CAD$)	1.00	0.00	3.15	10.91	1.42

Performance

	1 year	3 year	5 year	10 year
MSCI USA ESG Leaders Index (CAD$)	16.14	14.87	12.70	15.45
MSCI USA Index (CAD$)	18.61	15.12	13.08	16.28

Source: MSCI Inc. December 31 2020

This report card tells you that compared to the MSCI USA Index (the benchmark) the ESG screened MSCI USA Leaders Index has:

- the same risk and return characteristics
- double the percent of AA or AAA ESG rated companies
- 23% smaller carbon footprint

BMO's other ESG Leaders ETFs:

- Canada – ESGA - https://www.bmo.com/gam/ca/advisor/products/etfs?fundUrl=/fundProfile/ESGA#fundUrl=%2FfundProfile%2FESGA
- EAFE – ESGE - https://www.bmo.com/gam/ca/advisor/products/etfs?fundUrl=/fundProfile/ESGE#fundUrl=%2FfundProfile%2FESGE
- Global – ESGG – https://www.bmo.com/gam/ca/advisor/products/etfs?fundUrl=/fundProfile/ESGG#fundUrl=%2FfundProfile%2FESGG

As well as our fixed income offerings, ESGB and ESGF, share similar merits.

While ESG is growing, we are in the early years and there continue to be uncertainties that need to be worked out. ESG introduces a whole new layer of complexity to the investment management process with new data points and plenty of room for interpretation. Implementing a transparent index-based RI solution will offset many of these issues; it's easier to achieve consensus and to make progress, it has universal application and it's easily measured and monitored. Instead of being a barrier to growth, the scalability of an Index based ESG solution will grow with your Family Office or Investment Counselling firm.