Consumer Guide to **Responsible Investing**

BMO

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What is **responsible investing?**

Investment priorities are changing. More and more people are concerned both with the investment returns they can make on their savings, and whether their money is being managed in a sustainable way.

Reasons why you may want to invest responsibly...

- **You may not want to** invest in companies that pollute or damage the environment, deal in the arms trade or support child labour.
- **You may not want to** tolerate tobacco companies or those that profit from gambling, pornography or the production of alcohol.
- **You may want to** invest in funds run by managers who engage with the companies they invest in to encourage them to improve their business practices.
- **You may want to** invest in companies actively working to find solutions for global challenges such as climate change.

Making a difference

More and more we are trying to "do our bit" – we recycle our waste, perhaps buy free range or organic food, and seek out more energy-efficient white goods. We can extend this principle to our investment decisions too.

As the saying goes "money talks". It's true – we can make a difference by where we choose to invest our savings, pensions and ISAs without compromising on the opportunity to grow our money.

On the following pages we share our thoughts on responsible investing. As ever, the world of investments is about expectations, not certainties. However, the views we hold are all based on over 30 years' experience running a broad range of investment funds with a responsible remit.

Understanding 'ESG' – three key areas in responsible investing.

Environmental – how does a company's activities impact on the world? If they pollute for example, what steps do they take to reduce their contribution to things like global warming?

Social – here we consider factors like how a company treats its workforce, suppliers and customers.

Governance – this relates to how a company is run. Does a company have the right structures in place to ensure it is well managed? And how does it decide executive pay?

Paying the price

History provides many examples of what can happen when businesses fail to consider and prioritise environmental, social and governance (ESG) related factors. By investing in a responsible fund, you can avoid investing in companies operating in a manner that contradicts your values. The investment merits of such an approach are increasingly recognised.

Deepwater Horizon disaster

In April 2010, the explosion and sinking of the BP operated Macondo Prospect led to the Deepwater Horizon disaster, the largest marine oil spill in US history. BP bore the brunt of blame with cost-cutting and poor safety systems cited as contributing factors.

-50%

BP's share price between 20 April and 29 June 2010 The total costs borne by the company were around US$62 billion.

City A.M.

Volkswagen emissions scandal

Announcements by Volkswagen in late 2015 about manipulation of emissions data of engines, reportedly affecting over 11 million vehicles worldwide, raised extremely serious concerns about the commercial impact on the company, the reputational impact on the Volkswagen brand and the potential penalties arising from legal action in the US and Europe.

+US$33 billion

already paid out by the company, and more to follow.

Reuters UK

Rana Plaza collapse

In April 2013, the Rana Plaza clothing manufacturing factory collapsed in the Bangladeshi capital of Dhaka. The incident resulted in more than 1,100 fatalities and was a result of poor building structure. Many international clothing brands were supplied directly and indirectly from the factory. It brought worldwide attention to the working conditions in Bangladesh as well as the practices of the global multi-national corporations sourcing from the country.

+1,100 fatalities

as a result of poor building structure.

Reuters UK

The way people's pensions and savings are managed should not be isolated from their personal values.

The Most Reverend Justin Welby, Archbishop of Canterbury, President of the BMO Responsible Investment Advisory Council

The new investment reality – performance of responsible funds

When responsible investing first began, the perception was that principles might mean a trade-off with investment returns. But decades of evidence in responsible investing, where avoiding companies with poor environmental, social and governance credentials, and positively targeting companies that respect their workforce, suppliers, customers and the environment, demonstrate that good choices can be made that deliver strong long-term investment returns.

Performance with principles

But don't just take our word for it. Numerous studies have looked at how sustainability and governance link to a company's performance and that of its shares.

Responsible investing moving mainstream
The UN Principles for Responsible Investment have more than 2,000 signatories from over 60 countries, representing over US$80 trillion of assets.[1]
88% of senior business leaders believe that greater integration of sustainability issues in financial markets will be essential to making progress.[2]
Barclays found that a portfolio of corporate bonds[3] biased towards companies with good governance generated 5.5% outperformance over 7 years versus companies without good governance.[4]
A review of over 200 academic papers found that 88% showed a link from good ESG practices to good business performance.[5]
Morgan Stanley analysed over 10,000 open-ended[6] mutual funds[7] over 7 years – 64% of the sustainable equity[8] mutual funds had equal/higher returns and equal/lower volatility compared with non-ESG products.[9]

But isn't responsible investing riskier?

Investing places capital at risk and it's generally known that diversification (holding a selection of different investments) reduces risk, so if you screen (exclude) companies out on ethical grounds, you are potentially limiting the number of companies you can invest in. As a result, you may be taking on more risk.

The flip side is that less responsible companies are running risks to their business by neglecting social or environmental practices. This puts them at risk of a whole range of costs such as regulatory fines, supply chain interruptions, labour disputes, or loss of reputation. This could then have a detrimental effect on their credibility, performance and future profitability.

Many now hold the view that sound corporate governance, robust management of environmental and social risks, and the pursuance of strong business ethics play an increasingly important role in delivering investment performance. None-the-less investing responsibly is still investing and the value of investments can go down as well as up as a result of market movements. You may not get back the original amount invested.

[1] UNPRI (United Nations' Principles for Responsible Investment) 2019
[2] The UN Global Compact – Accenture CEO Study on Sustainability 2016 "Agenda 2030: A Window of Opportunity" (Accenture, 2016) https://www.accenture.com/us-en/insight-un-global-compact-ceo-study-sustainability
[3] A form of loan issued by a company in order to raise capital and an alternative to issuing stock through a rights issue. Bonds pay a fixed rates of interest over a fixed term, with the principal repaid at maturity.
[4] Barclays – Sustainable investing and bond returns https://www.investmentbank.barclays.com/our-insights/esg-sustainable-investing-and-bond-returns.html
[5] From the Stockholder to the Stakeholder – How Sustainability Can Drive Financial Outperformance, (University of Oxford & Arabesque Asset Management, March 2015)
[6] Investment funds that are not restricted in the number of shares they may issue.
[7] An investment vehicle made up of funds collected from many investors for the purposes of investing in securities.
[8] Shares in a company listed on a stock exchange. Shareholders are effectively the owners of the company and typically have the right to vote on company matters.
[9] Morgan Stanley Sustainable Reality Report – http://www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf

The Spectrum of **Responsible Investing choices**

Responsible investing is a broad umbrella under which different methods of investment fall.

Spectrum of responsible investment approaches

Traditional Investing

Limited or no regard for ESG practices.

ESG Integration

The systematic and explicit inclusion of material environmental, social and governance (ESG) factors into investment analysis and investment decisions.

Sustainability Focus

Approaches that select investments on the basis of leadership in environmental, social and governance aspects.

Impact Investing

Investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.

Exclusionary screening

Prohibitions of investments along certain themes, activities, or industries.

Philanthropy

Donation/ support of good causes.

Thematic

An investment style that can be found within a variety of investment approaches, focused around different theme(s) such as climate change, clean water, renewable technologies etc.

Although responsible investment is moving mainstream, its reach, related components and associated jargon can prove daunting. There has been a confusing array of terminology for responsible investment approaches, which have been used interchangeably over the years. This lack of consistency has made it harder for advisers to compare like with like. The Investment Association has therefore launched an industry-wide common language for responsible investment, which we have incorporated into this spectrum. The approaches described are not mutually exclusive and typically a combination will be used.

Understanding stewardship

The Investment Association adopts the definition of "Stewardship" according to The UK Stewardship Code 2020 of the Financial Reporting Council:

> Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.[1]

'Stewardship' is a specialist discipline adopted by Investment Managers that are looking to engage and influence companies in areas such as Sustainable and Impact investing.

What does it involve in practice?

At the individual company level, stewardship entails:

- Setting expectations, for example on companies' ESG practices
- Oversight of assets and service providers
- Engaging with senior management and holding them to account
- Exercising investor rights and responsibilities (e.g. voting)
- Escalating concerns

Stewardship is also applied at the fund level, where it importantly differs according to asset class and geography because there is no 'one size fits all' for influencing positive change.

[1] https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf, p. 4. The Investment Association reserves the right to review its alignment with the FRC definition at any time.

The Sustainable Development Goals – **roadmap to a better future**

Investing in companies and using the Sustainable Development Goals (SDGs) as an engagement framework provides a roadmap for building a more sustainable world.

Individuals increasingly want to make a positive impact. As consumers, there is a growing recognition that we can align our investment decisions with our values. Ultimately, we want our money to drive improvement in the world around us.

Finding solutions typically requires a global perspective together with commitment and coordinated action from international organisations, governments, companies and individuals. We all have a role to play and the Sustainable Development Goals (SDGs) were designed with that in mind.

The SDGs set out a roadmap for a more sustainable global economy and society by 2030. Developed by the United Nations, they were endorsed in 2015 by all 193 member states.

The 17 SDGs are ambitious high-level goals with 169 granular targets, which provide a universally-recognised framework for assessing and accelerating progress towards a more sustainable world. The SDGs provide a clear framework for investment specialists to encourage improvement within investee companies.

"We must strongly accelerate our broader efforts to achieve the Sustainable Development Goals...and we need increased financing for those solutions."

UN Secretary-General António Guterres, 2019

Engaging for **positive change**

Responsible investment means more than seeking out sustainable returns; its core purpose of 'doing good' must prevail. Asset managers can use their influence as stewards of capital to encourage best ESG practice at companies through constructive engagement to ultimately drive a more responsible world.

Engagement delivers the best outcomes when it focuses on the right issue for the right company at the right time. Engagement should therefore vary by company and the ESG issues at hand, ranging from ongoing dialogue with boards and senior executives to dedicated site visits. However, sometimes one-on-one engagement with a company is not enough and the level of engagement needs to be escalated. Below is an overview of different approaches for engagement.

Collaboration: Expressing concerns collectively with other investors can help get companies' attention.

Using your voice at the ballot box: Voting against management on key resolutions sends a clear signal to companies and might help with further engagement efforts.

Attending Annual General Meetings (AGMs): AGMs offer the opportunity for direct, public dialogue with boards and top executives. Interventions at AGMs can also trigger further dialogue with a company, paving the way to more in-depth engagement on an issue.

Filing shareholder resolutions: These can be a key rallying point of an engagement campaign to change companies' behaviour. Examples might include improving board accountability, executive pay practices, ESG-related disclosure or climate change action.

Divestment: Selling a holding can be a powerful signal of dissatisfaction, though it removes some options for future interaction such as the use of the vote. It is often a measure of last resort.

Measuring impact

There is an increasing investor interest in understanding the positive impact of investments: while performance can tell us what the financial return of an investment is, how can sustainability returns be measured?

SUSTAINABLE DEVELOPMENT GOALS

The Sustainable Development Goals (SDGs) are a key reference point being used to try to measure impact. The 17 goals provide a useful tool for companies and investors to be able to contribute to achieving the ambitious, global objectives of the 2030 Agenda.

Shifting perspectives

Perspectives on stewardship are beginning to shift, from interpreting it as the relationship between investors and individual companies, towards looking more holistically at our responsibilities for shaping the market and economy as a whole. Climate change is perhaps the most obvious example of a systemic risk which investors can help to address, but it is not the only one. Critical issues such as ocean health, biodiversity and public health cannot be addressed by engagement with companies alone.

Implementing this practice means a sharper focus than in the past on public policy, but also building relationships with other stakeholders, including Non-Governmental Organisations (NGOs) and academic experts. A collaborative approach between investors is key to making this a success, both to muster the resources necessary to make these changes and to present a unified voice which improves the chances of successful influence.

"Be a global citizen. Act with passion and compassion. Help us make this world safer and more sustainable today and for the generations that will follow us. That is our moral responsibility."

Former UN Secretary-General, Ban Ki-moon, 2015

Want to find out more?

For more information on BMO Global Asset Management or our range of funds please contact your financial adviser.

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