

No Longer Niche

Responsible investing has evolved to become a critical component of the investment process and more





Interest in responsible investing has been accelerating over the past 50 years. At first, it was about investing with values in mind, but the enthusiasm for this approach goes well beyond that today.

Investor demand and rising risks related to climate change, a shifting regulatory environment and a growing awareness of social inequities have been catalysts driving growth in this approach in recent years.

But the shift to responsible investing has another benefit: it can enhance the investment process that creates the potential for stronger and more stable returns.

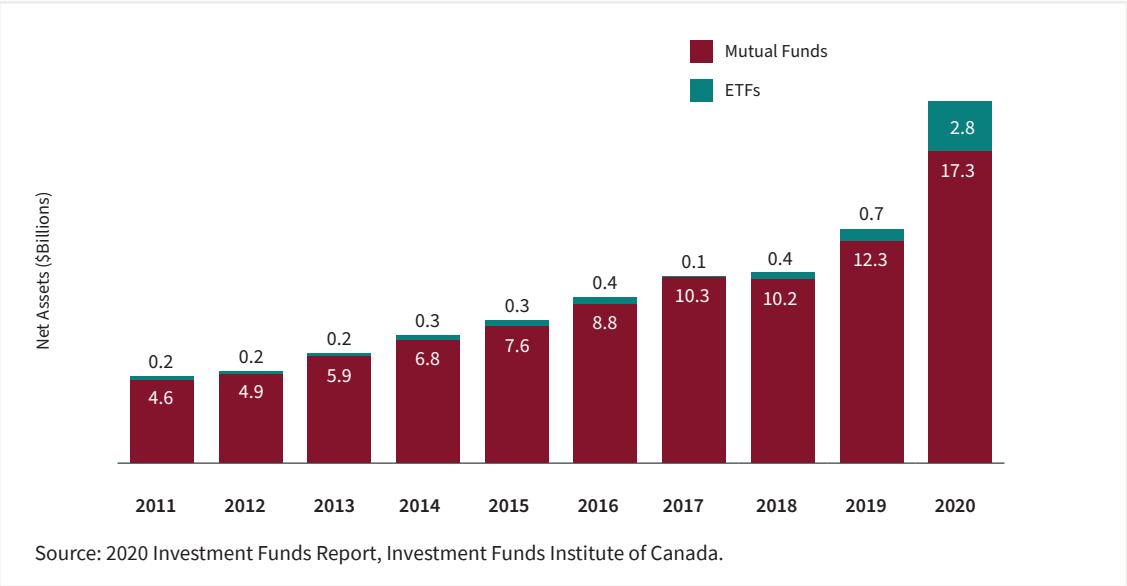
Research suggests companies with strong responsible investing credentials tend to be more resilient during market crises. The COVID-19 pandemic provided a great opportunity to show how responsible investing can benefit investors. In January 2021, Morningstar looked at the performance of 11 ESG equity index funds during 2020 relative to their more traditional index fund peers. All 11 funds outperformed.¹

Responsible investing has grown, driven by client demand

Responsible, or sustainable, investing means incorporating environmental, social and governance (ESG) factors into the process of selecting and managing investments. While the concept has been around since the 1970s when the first mutual fund launched with this focus, it continues to evolve and grow in popularity. Net assets in ESG mutual funds and ETFs in Canada alone have quadrupled since 2011, reaching over \$20 billion in 2020.²

Institutional and retail demand has been driving the growth in responsible investing funds. It’s all part of a greater public awareness of ESG issues and a broader trend toward greater transparency around how investment dollars are used and the desire to see those funds drive real-world outcomes.

Growth in Canadian RI Funds



“Responsible investment fund assets grew by 55% in 2020, compared to 11% growth for the fund industry overall.”³

There are good reasons behind responsible investing's results

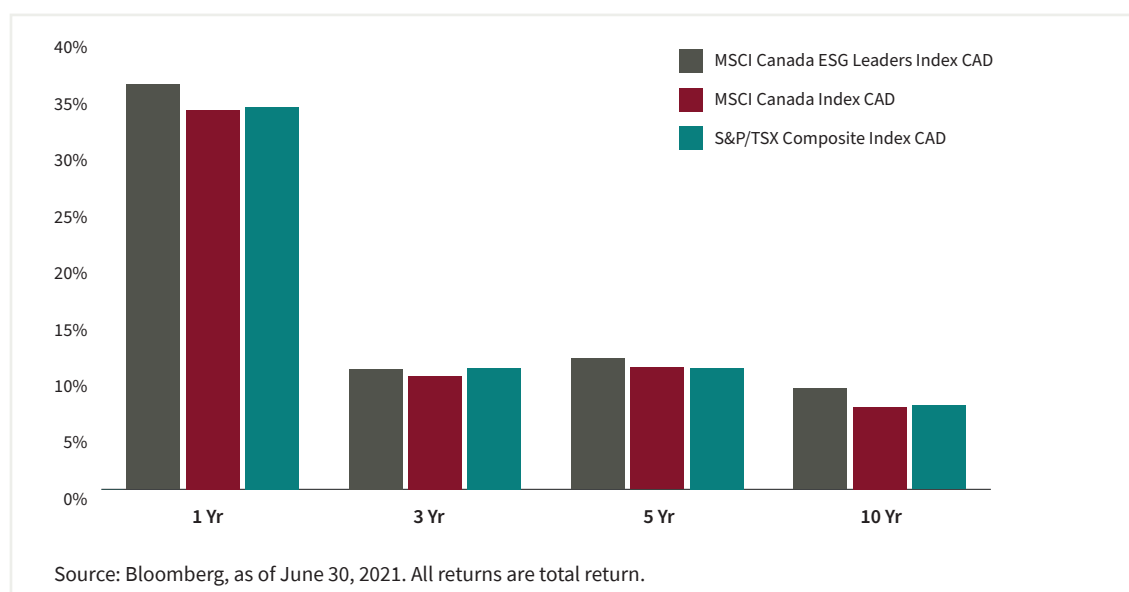
Investors have long worried that investing responsibly meant sacrificing higher returns. However, there is ample evidence to debunk this myth. The UN Principles of Responsible Investment cites a 2018 literature review of more than 2,000 academic studies on the effect of ESG factors on corporations' financial performance. The analysis found just 10% of the studies showed a negative relationship.⁴

Responsible investing includes applying ESG-specific techniques to reduce volatility and highlight risks and opportunities that might otherwise be overlooked.

Assessing a company's ESG performance provides a more thorough view of an organization's management practices and prospects. Higher ESG scores can lead to lower costs of capital and better long-term operational decision-making.

The performance of ESG index funds demonstrates that they have kept pace, or better, with their traditional index peers. Over the past 10 years the MSCI Canada ESG Leaders Index has returned 8.9%, outperforming the broader S&P/TSX Composite by 149 basis points.⁵

Canadian ESG-focused funds are highly competitive



Responsible investing is a critical component of the investment process

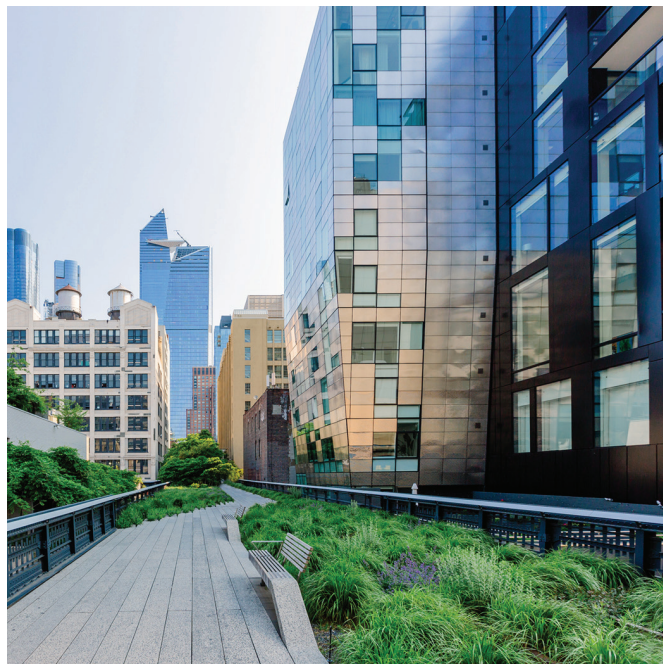
Responsible investing involves looking at all aspects of a company, not just its financials. It means analyzing the wider environmental, social and governance impact of management's decisions and assessing whether they contribute to the company's long-term growth or just the next quarter's profits.

Ignoring ESG factors can result in a wide range of risks – financial and legal penalties, loss of valuable equipment and licenses, brand and reputation damage, supply chain disruption – detracting from performance and leading to substantial shareholder losses.

Given the consequences, it isn't surprising that investors increasingly want to know that their fund managers are conducting appropriate reviews and risk mitigation when it comes to the companies they invest in. ESG screening can be an important tool for that and a critical part of the investment process. Canada Life's Investment Manager Review (IMR) process incorporates ESG screening for this very reason.



In recent years, there have been some notable examples of ESG risks that were ignored, resulting in substantial losses.



Environmental risk:

Prolonged drought and rising temperatures are increasing the risk of forest fires, putting a greater burden on companies to ensure they're operating safely. Pacific Gas & Electric (PG&E) has found out the hard way that prioritizing profits over maintenance costs can end badly. The Californian utility has been found responsible for numerous wildfires in the state, including the deadly 2018 Camp Fire, which started when a live wire fell from a PG&E tower 25 years past its replacement age. The company eventually reached a US\$13.5 billion settlement and pled guilty to involuntary manslaughter in the deaths of 84 people. Since the disaster, PG&E shares have returned a cumulative -77.3%, compared to -11.6% for the U.S. energy sector and 71.5% for the broader U.S. market over the same period.⁶

Social risk:

Community opposition can shut down a project, even one with regulatory approval behind it. Rio Tinto learned this at great cost in 2020 when it knowingly destroyed sacred Aboriginal rock shelters in Western Australia in order to mine iron ore. While the miner's actions were legal, the move was widely condemned. Pressure from investors eventually led to resignations by three senior executives. An Australian government inquiry has recommended Rio Tinto rebuild the 46,000-year-old cave system and compensate the traditional owners. The ordeal was arguably a factor that contributed to the company underperforming its peers by more than 6% in the months that followed.⁷

Governance risk:

For over 14 years, Wells Fargo employees fraudulently opened client accounts to meet sales targets that the bank admits were unreasonable. The bank has paid US\$5.9 billion in various fines and settlements, including \$500 million to the Securities and Exchange Commission to compensate investors who suffered from Wells Fargo's attempts to cover up the true state of affairs at its community banking arm. Former executives are under criminal investigation and the Federal Reserve imposed growth limits on the bank in 2018 until it could prove better behaviour. The cumulative return on Wells Fargo shares, from the end of 2015 to June 30, 2021, is -1.1%, compared to 133.9% for the broader U.S. market and 99.5% for the U.S. banking industry.⁸



Responsible investing continues to evolve

One of the challenges of responsible investing is the lack of industry standards for rating a company's ESG qualifications. There are several highly regarded ESG scoring systems available, each with a different focus. Some look at the investment philosophy of the firm, but do not provide evaluations at the specific fund level. Others evaluate individual holdings of a fund, but do not consider the intentions or strategy of the fund manager.

At Canada Life, we've been incorporating ESG in our overall IMR process for years and we continue to evolve and refine our ESG methodology as the industry matures.

A vital component of our ESG IMR process is in-depth discussions with fund managers. Those discussions, examining topics of importance to clients, help us determine who is integrating ESG well versus those who are merely going through the motions. The team has seen a growing number of fund management firms with dedicated ESG resources and reporting, a trend that will continue thanks to increasing expectations from investors and regulators.



S&P Global Market Intelligence looked at the performance of 26 ESG mutual funds and ETFs with AUMs larger than US\$250 million. It found in the 12 months after COVID-19 was declared a pandemic, 19 had outperformed the S&P 500.⁹



Responsible investing in action

At Canada Life, aligning with current regulations and the highest ethical standards is paramount. We're also committed to bringing quality, best-in-class investment solutions to the marketplace that meet clients' needs through today's changing market dynamics. "Canada Life incorporates responsible investing at two levels – in its use of ESG elements to assess fund managers and funds, and by offering select sophisticated investment solutions designed with both responsible investing and fund performance in mind," says Brent MacLellan, VP Portfolio Construction and Analysis.

The IMR team's three-step process underpins the quality and strength of our investment offerings. Using a rules-based approach, the team evaluates all the managers and funds on our platform according to qualitative, quantitative and early trend analyses. How a fund manager incorporates ESG factors into their investment analysis a key consideration within the IMR team's manager

evaluation framework. In 2021, we identified an opportunity to further strengthen and formalize this ESG evaluation so that it's now a core part of our qualitative analysis.

The result is a high degree of consistency in the assessment of every manager – everyone goes through the same rigorous process and is assessed according to the same criteria. "It's a level of research that can be challenging and time-consuming for individual advisors or investors to tackle on their own. We're seeing increasing demand from advisors, consultants and clients to have a better understanding of who's best in class when it comes to incorporating ESG into their investment process, and our IMR process evaluates that," MacLellan says.

Beyond investment management teams using responsible investing tools to measure such business decisions and their outcomes, investors also have the option to make more proactive choices, thanks to the thriving ESG-related market.

We're focused on providing Canadians with financial solutions that meet their needs. That's why we're enhancing our managed solutions offering by adding Canada Life Sustainable Portfolios – three sophisticated strategies designed to help clients responsibly invest for returns while aligning with values.

Canada Life Sustainable Portfolios



Are purpose-driven to align with investors' values. They look to invest in companies that demonstrate strong ESG practices to help clients make a positive contribution to a more sustainable world.



Are performance-focused. The portfolios draw on multiple sources of return through globally-diversified exposure across equities and fixed income. This can help the portfolios weather different market conditions, maintain a specific level of risk and deliver the potential for strong risk-adjusted returns.



Leverage the strength of powerful partnerships with investment experts who navigate the portfolios through changing markets and ensure they stay aligned to investors' objectives, risk tolerance and values – all to set a foundation for continued success.

For more information about each of the Canada Life Sustainable Portfolios, talk to one of your Canada Life Wealth wholesale team members or visit the marketing toolkit.

¹Hale, John. (2021). *Sustainable Equity Funds Outperform Traditional Peers in 2020*. Morningstar. <https://www.morningstar.com/articles/1017056/sustainable-equity-funds-outperform-traditional-peers-in-2020>.

^{2,3}The Investment Funds Institute of Canada (IFIC) (2020). *2020 Investment Funds Report*. IFIC. https://www.ific.ca/wp-content/themes/ific-new/util/downloads_new.php?id=26009&lang=en_CA

⁴Principals for Responsible Investment (PRI). *What is responsible investment?* PRI. <https://www.unpri.org/an-introduction-to-responsible-investment/what-is-responsible-investment/4780.article>

⁵Bloomberg, as of June 30, 2021. All returns are total return.

⁶Bloomberg. Share performance of PG&E Corporation, S&P 500 Energy Sector GICS Level 1 Index and S&P 500 Index are from December 31, 2017 to June 30, 2021.

⁷Bloomberg. Share performance of Rio Tinto Ltd. is from June 8, 2020 to October 8, 2020.

⁸Bloomberg. Share performance of Wells Fargo & Co., S&P 500 Index and S&P Banks Industry Group GICS Level 2 Index are from December 31, 2015 to June 30, 2021.

⁹Whieldon, Esther & Clark, Robert. (2021). *ESG Funds Beat Out S&P 500 in 1st Year of COVID-19; How 1 Fund Shot to the Top*. S&P Global Market Intelligence. <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/esg-funds-beat-out-s-p-500-in-1st-year-of-covid-19-how-1-fund-shot-to-the-top-63224550>



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