Why ESG investing doesn't have to be a compromise

By Mark Stacey And Grant Wang

Responsible investing that focuses on positive environmental, social and governance (ESG) initiatives has traditionally been characterized as a compromise – good for the soul, not so good for portfolio returns.

But that need not be the case anymore. Increasingly, companies who make strong contributions to society are being found to have strong share prices that go with it, suggesting investors who want to do right can now have their cake and eat it too.

The growing recognition of ESG as an important driver of return can be attributed in large part to stricter regulations that require companies to disclose more aspects of their ESG mandates, alongside stiffer penalties for those who run afoul of them. This beefed up regulatory framework has spawned a new set of metrics to evaluate the parameters of responsible corporate behaviour, which, in turn, has given investors an expanding archive of financial data that can be used to quantify ESG winners and losers.

More than that, however, it has provided investors the ability to assess the impact, if any, such rankings may have on a company's overall risk/return profile. As a result, mounting evidence has emerged that shows companies with favourable environmental, social and governance profiles regularly outperform their peers and exhibit positive attributes that can help mitigate potential losses. Based on some of our research, strong ESG mandates are associated with above-average risk control and compliance standards, leading to less frequent incidences of fraud, embezzlement, corruption or litigation that often coincide with heavy fines and plummeting stock values.

This isn't to say there's always a clear understanding of the correlation between socially responsible corporations and better performance. By most counts, there is well over 100 different ESG factors to choose from, but only a small percentage have the necessary data backing them to provide solid proof of their potential connection to future returns.

Take, for example, our new AGFiQ Enhanced Global ESG Factors ETF (QEF) which seeks to balance capital growth with societal contribution, while providing core exposure to global equities that closely track the sector and geographic allocation of those making up the MSCI ACWI Index (see chart 1).

The fund's universe of stocks starts from the premise of excluding companies in the tobacco and defense industries as well as those with severe ESG controversies such as Eni S.P.A., a multinational oil and gas company that has been making headlines for alleged corrupt behaviour in various countries it does business.

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In addition, we analysed dozens of separate ESG factors to determine which ones have significant positive correlations to future returns, but just seven (see chart 2) of these factors ended up offering enough proof for us to use them confidently in the fund. We also found that some in this group have more predictive power than others. For instance, governance scored high in our testing, as did carbon emissions and waste. At the same time, the two social sub-factors we settled on were the least predictive of positive future returns, but still provided strong enough evidence of their potential to enhance overall performance, not detract from it.

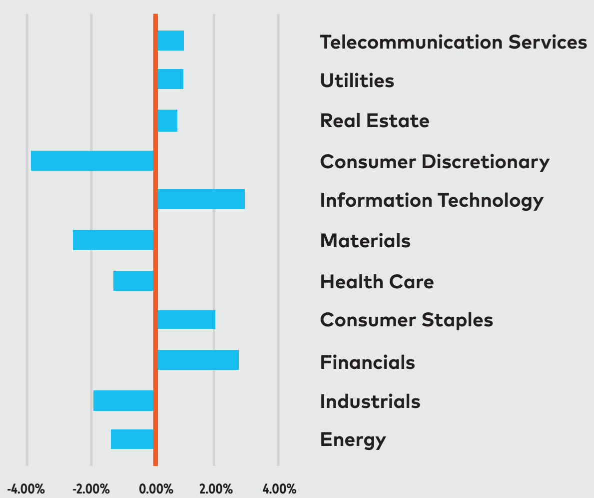
These findings aren't set in stone, and constant monitoring and rebalancing is needed to reflect corporate changes and market events that may result in revised return expectations over time.

In doing so, we can ensure that the mandate of the fund remains consistent and relevant with the changing ESG landscape.

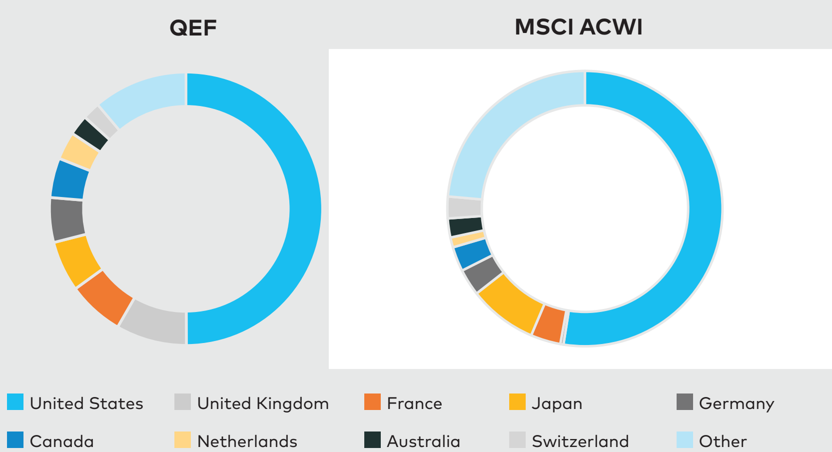
Ultimately, the ability to quantify environmental, social and governance factors in an objective, transparent and consistent manner is helping move responsible investing into the mainstream. Not just because it helps clarify those companies who are most committed to improving society, but because it can help improve an investor's risk/return profile and be an important driver of future performance.

A Mainstream Investment: AGFiQ Enhanced Global ESG Factors ETF (QEF)

Over/Under Sector Allocations



QEF vs MSCI ACWI Country Allocations



Source: AGF Investments Inc. AGFiQ Enhanced Global ESG Factors ETF as of March 31, 2018

The Group of Seven

Environmental	Social	Governance
• Carbon Emissions and Waste • Toxic Emissions and Waste	• Health and Safety • Labour Relations/ Management	• Percent of Women at Board level • Governance • Governance Disclosure

Source: AGFiQ

About the Authors

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Mark joined Highstreet Asset Management Inc. (Highstreet) in 2011 and today leads the firm's investment management functions. He is also responsible for portfolio management of the Highstreet Canadian small cap and Canadian growth equity mandates. Mark has 14 years of investment experience applying quantitative and qualitative management techniques to the portfolio management process.

Mark has a Masters of Industrial Relations from the University of Toronto and an MBA from the Richard Ivey School of Business, University of Western Ontario. He is a CFA charterholder.

Prior to joining Highstreet, Mark was Vice-President, Equities at London Capital Management for six years where he managed a variety of core, value and growth-oriented Canadian and U.S. portfolios.

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Grant joined Highstreet Asset Management Inc. (Highstreet) in 2012 and leads the research team to develop and enhance Highstreet's quantitative investment strategies. He plays a key role in facilitating the sharing of ideas between Highstreet's portfolio managers and quantitative specialists with respect to research proposals and findings.

Prior to joining Highstreet, Grant spent seven years as a lead quantitative researcher for one of Canada's largest pension funds. He has 15 years of experience developing predictive statistical models.

Grant has a B.A. and M.A. in Economics from Nankai University, and a Ph.D. in Economics from University of Western Ontario.

For more information on the full lineup of AGFiQ ETFs, visit AGFiQ.com.

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