Responsible Investment 101:

An Introduction to Responsible Investing
by
Alberta Investment Management Corporation (AIMCo)

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"In recent years…non-financial factors - including environmental, social and governance factors - have figured ever more prominently in the value of corporations. " July 2008, CFA Institute

1.0 Introduction

Today there is a growing recognition that institutional investment managers (IM's) are uniquely positioned, as stewards of pension funds, government funds and private funds, to positively influence investee firms' corporate governance and business practices. They hold the lion's share of investments in the global economy, at USD $71.1 trillion (2010)[1], and can leverage patient capital over the long-term, directly influencing deal-flow and economic outcomes. Responsible investment (RI)[2] incorporates environmental, social and governance (ESG) factors into investment processes and seeks long-term value for investors, the market, and society as a whole. Public demand for RI post the global financial crisis has contributed to the financial community's adoption of the UN-backed Principles of Responsible Investment (PRI) with 1,000 institutional members and $34 trillion in assets under management, or 15% of global investable assets.[3]

AIMCo's approach to RI is multi-dimensional and is guided by our core values, our clients, our long-term investment horizon and our fiduciary duty. Our approach was formalized when we became a signatory to PRI in October 2010. AIMCo invests in companies that uphold internationally accepted norms of good behavior (a 'normative' RI approach) and practices due diligence by considering the positive and negative ESG aspects of the vast majority of our investments (a 'beta' or risk-based RI approach). AIMCo also pursues a 'relationship-investing' strategy across some of its high concentration investments, by focusing on firm governance in order to improve firm performance. AIMCo's RI strategy extends to its asset mix by including certain 'positively themed' (E) and (S) assets such as alternative energy, sustainable real estate, timberlands and core infrastructure; and it also features 'negative screens' or exclusions applied to certain direct investments, such as the tobacco industry, or to certain prohibited countries.

Academic studies corroborate the findings that the business case for RI is growing ever stronger due to a combination of factors: 1) Eco-efficiencies drive down costs and improve net present values over time[4]; 2) Reduction of ESG risk corresponds to reduced investment risk[5]; 3) Specific governance measures correlate with improved performance[6]; and 4) Potential reputational risk (upside and downside) has risen due to the universal reach of the internet. Integration of RI is necessarily uneven amongst IM's, across countries, and even internally between asset classes, which is a reflection of cultural protocols, stakeholder demand and IM organizational strategy. RI is a journey rather than a destination.

2.0 Outline

This paper outlines defining attributes and the business case for RI and then explains AIMCo's approach, illustrating AIMCo's RI structure or 'pillars' and AIMCo's overall implementation of RI. The paper concludes by summarizing key learnings and further implications for the RI landscape in Canada.

3.0 Defining Attributes of RI

How does one define responsible investment? The answer is 'it depends.' Each IM's interpretation of RI cascades from its own world view, cultural and regulatory considerations, how it perceives its fiduciary duty to stakeholders, who its stakeholders are and its investment strategy. However, there is evidence that normative RI practices are emerging regionally and may converge globally at some point, such as criteria for director independence and board diversity.[7]

RI has a long-term, intergenerational investment horizon. Engaging with companies to improve their ESG metrics does not translate into improved risk-adjusted performance overnight. RI recognizes the business case for paying attention to ESG metrics from both a risk and a performance perspective. ESG factors that might traditionally be viewed as non-quantifiable often emerge as material and quantifiable over the long term, such as insufficient attention to worker safety, potential environmental impacts, regulation readiness and reputation and branding.

RI is concerned with promoting system stability. IM's are expected to play an advocacy role by promoting shareholder rights and by responding to proposed changes in regulations that could impact those rights. According to the PRI, IM's should encourage companies to disclose their ESG practices (Principle 3)[8]; however IM's should also be mindful of the unintended consequences of disclosure, such as the justification of outlandish pay packages owing to precedence in the industry;[9] or of compromising business strategy by inadvertently divulging it to competitors.

RI recognizes there are finite limits to non-renewable resources, and high environmental impact industries like extractives must commit to managing thresholds to mitigate negative environmental impacts and build social equity (social license to operate) with appropriate stakeholder consultation.

4.0 Business Case for RI

It should come as no great surprise that the business case for paying attention to ESG factors is fairly strong. A 2007 Mercer review of 36 academic studies attempting to track the relationship between RI and financial performance found that 20 had a positive relationship, 3 had a negative relationship, 8 had a neutral relationship, 2 were positive-neutral and 3 were negative-neutral.[10] The Mercer findings demonstrate that an RI strategy may not always correspond to expected returns but it generally makes business sense.

RI is increasingly relevant to investment research, risk and asset allocation, performance monitoring, proxy voting, engagement strategy, and the decision to invest, divest, or screen. Risks that were traditionally deemed 'extra-financial' are now recognized as having potential financial impacts, such as quality of corporate governance, market sentiment, reputational risk, and the impact of globalization. The reality of climate change is now a key environmental risk that businesses and municipalities must attempt to mitigate on the input side by reducing emissions, and on the receiving side with flood and crop insurance.[11]

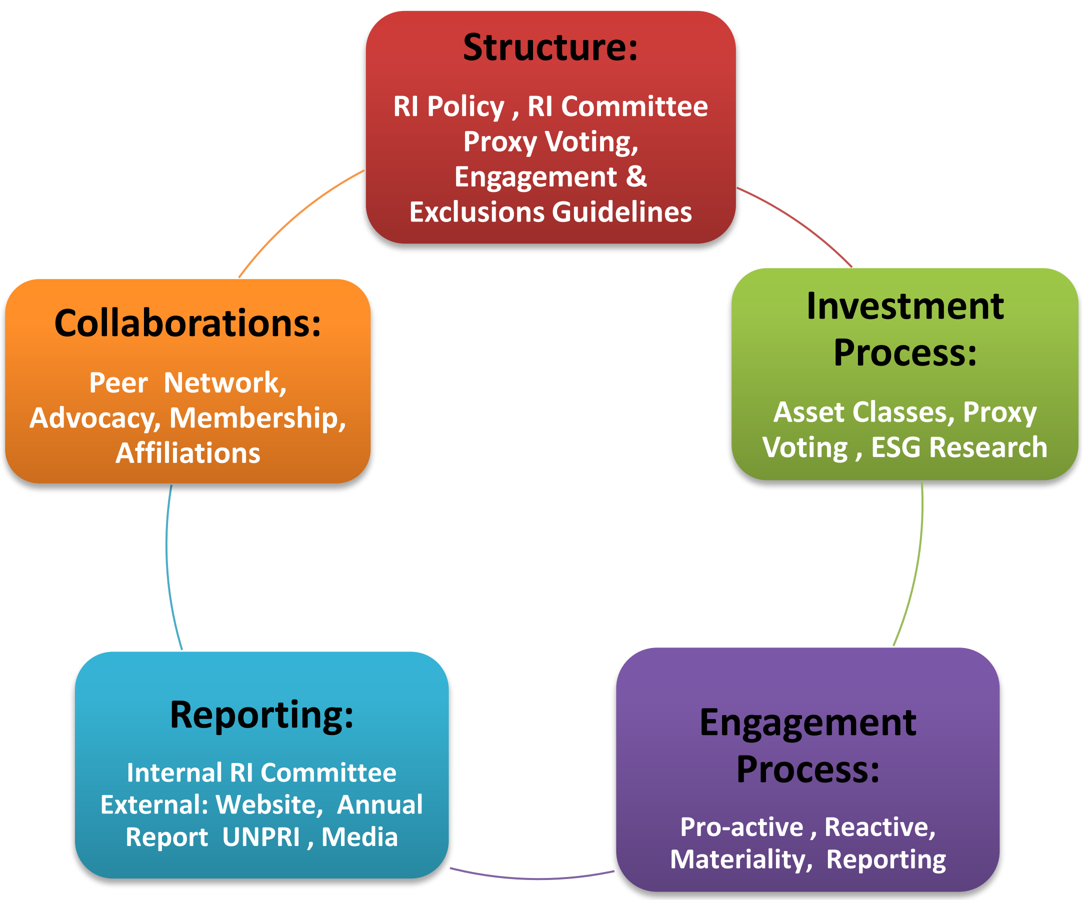
Academic studies substantiate the strong positive relationship between good governance and valuation outcomes for the criteria of board composition, ownership structure, and the presence of an institutional investor[12]; while the criteria of effective compensation structure, ESG disclosure and shareholder rights each indicate higher firm performance.[13] Engagement with investee firms on governance issues corresponds with improved performance over benchmark (alpha),[14] while engagement on environmental and social issues decreases risk relative to benchmark (beta.)[15] An ESG-tilted portfolio has been demonstrated to offer insurance-like protection[13], which may result in a higher credit rating and a lower cost of debt.[16]

The universal reach of the internet has changed how we receive information, so that negative news, whether it be an oil spill (E), or a factory collapse (S), or an instance of corporate malfeasance such as egregious bonuses (G), is circulated earlier and more rapidly, reaching a wider audience, and impacting share price, increasing reputational and financial risk and market volatility.

5.0 AIMCo RI Structure

In 2012-13 AIMCo formalized its RI structure with a board approved RI policy and core guiding documents including Proxy Voting and Corporate Governance guidelines, Engagement guidelines and Exclusions guidelines.[17] In 2012, AIMCo created an internal RI Committee with cross functional representation, chaired by the CEO, and assigned dedicated staff to oversee RI 'pillars' which align with UNPRI principles, including: 1) RI structure; 2) RI investment process; 3) Engagement processes; 4) RI reporting; and 5) RI membership body affiliations, Collaborations and Advocacy (See Figure 1.)

Figure 1. AIMCo's 5 RI Pillars



6.0 RI Implementation at AIMCo

AIMCo's Responsible Investment Policy extends across our AUM so that all asset classes are compliant with AIMCo exclusions and rely upon ESG research to some degree. RI implementation at AIMCo today includes the following RI activities: i) the exercise of shareholder rights in voting our proxies at annual general meetings around the world, and real-time, on-line disclosure of our voting stance and rationale; ii) pro-active and reactive engagement strategy with investee companies; iii) shareholder advocacy measures, including written responses to proposed changes to securities regulation; iv) collaboration with peers on company engagements and within the context of a peer proxy voting working group; and v) external and internal RI reporting for PRI, the annual report and for our clients.

While RI activities necessarily encompass holdings within public equities due to the nature of the proxy voting process, AIMCo certainly practices RI across all asset classes. AIMCo holds a significant proportion of board seats or enjoys board observer status across several direct investments within our private equity and private investment portfolios. This affords AIMCo a greater degree of influence upon corporate governance at these companies. All private direct investments are naturally reviewed within the due diligence phase for: (i) prior environmental liabilities and certifications; (ii) occupational health, safety and labour standards; (iii) community relations; and (iv) quality of corporate governance. Complicating ESG factors such as oil spills, industrial accidents, labour and safety issues and questionable corporate governance - such as pay misaligned with performance - are measures that are routinely considered within the investment monitoring process.

AIMCo's strategy of asset diversification supports positively themed ESG investments including alternative energy and core infrastructure, exemplified by our investment in Grupo Saesa, an electricity distributor in Chile. Of particular note is our real-estate portfolio, which features its own internal sustainability policy. A significant proportion of the real estate portfolio's Canadian investments achieve LEED® (Leadership in Energy and Environmental Design) and/or BOMA BESt (*B*uilding *E*nvironmental *St*andards) certification. Also of note is our venture capital portfolio which features a concentration of alternative energy investments including: solar, wind and even a solid oxide fuel cell technology investment (Bloom Energy).

6.1 Pro-Active and Reactive Engagement Strategy

The AIMCo RI Committee identifies focus areas to drive the pro-active engagement process in advance of the busy proxy season. For the 2013-14 year these are: (i) Environmental-climate change readiness and disclosure of environmental impacts; (ii) Social-worker safety; and (iii) Governance-director elections and shareholder rights.

For instance, as extractive companies are considered to have a high environmental impact we fully expect extractive companies we are directly invested in to disclose their environmental impacts and their strategy for mitigating the impacts. Similarly, for director elections, although majority voting has been adopted by 85% of the companies listed on the TSX, some boards still choose not to act on the outcome of the majority vote.[18] AIMCo is also a global investor and many investee companies do not practice majority voting, but use a default plurality system whereby withhold votes are not counted.

The April 24th 2013 Rana Plaza, Bangladesh factory collapse which resulted in the loss of over 1,100 lives clearly revealed a lack of attention by parent companies to worker safety and insufficient commitment to the principle of extended producer responsibility.[19] As worker safety is a recurrent issue in Bangladesh, pro-active engagement with companies that source apparel from Bangladesh is preferable to reactive engagement in order to mitigate the probability of future incidents. Woolworths sources clothing from 38 factories in Bangladesh. At a recent Johannesburg Stock Exchange conference (October 1st, 2013) AIMCo asked Justin Smith, the head of sustainability of Woolworths Holdings, why the company had not signed one of the official agreements committing companies to ensuring factory safety. Mr. Smith publically committed Woolworths to sign the Accord agreement,[20] which finally became official two weeks after this commitment.[21]

AIMCo managers will engage reactively if a company's policies or ESG activities raise operational, financial, environmental or social risks beyond an acceptable level. The decision to engage reactively is determined by the perceived egregiousness of the issue, RI best practice, international protocols, the rule of law, and invitations for collaborative engagement by peers. For example, last spring AIMCo joined a group of Canadian IM's to collectively voice their public disapproval with Barrick Gold's decision to award an extravagant $11.97 million signing bonus to the co-chair of the board, John Thornton, which was not tied to individual or firm performance.[22] Caisse de Depot requested AIMCo to participate in the joint media statement. AIMCo co-facilitated to broker the final media statement with bcIMC, OMERS, OTPP, PSP, Hermes, and Caisse de Depot.

This was the first time a major Canadian firm has ever lost a say on pay vote; however the vote was advisory and had no immediate impact upon the board, which was re-elected. More important was the precedent this action set, as a group of Canadian IM's representing $916 billion AUM collectively voiced their public disapproval of an egregious signing bonus. AIMCo continues to monitor pay practices at Barrick Gold.

In another reactive engagement example, AIMCo weighed in on the recent high profile proxy fight (March, 2013) that was led by Jana Partners against the incumbent Agrium board. Jana's proposal of a golden leash arrangement, unprecedented in Canada, offered differentially favourable compensation to the directors proposed by Jana compared to the rest of the directors. Jana's proposal to split the wholesale from the retail operations became secondary to this unusual corporate governance proposal. The CEO's for bcIMC and for AIMCo made separate, public statements to the media, voicing their disapproval of the Jana plan.[23] The outcome of these public acknowledgements was that the incumbent Agrium board succeeded, despite proxy advisory firm ISS' recommendations to support the Jana slate. Had these public statements not been made, the voting outcome may have been very different for Agrium, underscoring the impact of IM's voice on corporate governance.

6.2 Exclusions

Companies are excluded from the investment universe if they appear to be operating in contravention of legislation/international agreements or fundamental governance norms and may be divested from after engagement with the company fails. Most Canadian IM's, like AIMCo, prefer a strategy of 'voice over exit,' whenever possible, i.e. to engage with a firm and effect positive change rather than to divest. If a company no longer qualifies for exclusion, it may be re-included in the investment universe, which is not to say AIMCo will necessarily re-invest in the company. For example, although Finmeccanica S.p.A was re-included last spring as it no longer makes nuclear weapons, their CEO was arrested soon afterwards on charges on bribery and corruption - clearly not a recipe to build investor confidence.[24]

7.0 Reporting

AIMCo reports broadly on RI in the annual report, and more specifically in the PRI annual survey. All formal RI documentation, votes and voting rationale are disclosed on our external website.[25]

8.0 Advocacy and RI Member Organizations:

AIMCo participates in a Proxy Voting Working Group of Canadian peer IM's, which conducts research and facilitates advocacy efforts on our behalf. The working group attempts to address residual proxy voting issues in Canada including:

- The complexity of the voting system, with multiple parties, increases the margin for error.
- How votes are tabulated and how proxies are cast is unregulated, impeding vote confirmation.
- A misalignment between economic ownership in the issuer and voting power.[26]
- A regulatory 'gap' which enables activist shareholders to propose a dissident slate without informing all shareholders in advance, inadvertently encouraging 'stealth tactics' from US hedge fund firms. [27]

AIMCo welcomes the opportunity to respond to proposed changes to regulation and guiding documents for member organizations and supports a regulatory framework that provides stability and maximizes shareholder value. Last spring, AIMCo submitted letters regarding proposed changes to Instrument 62-103 and 62-104[28] (Early Warning System and related Take-over Bids) and to Instrument 62-105[29] (Shareholder Rights Plans) to advocate for shareholder voice. AIMCo also commented on proposed changes to the OECD Principles of Long-Term Investment Financing by Institutional Investors.

AIMCo is a fully-fledged member of the Canadian and the global RI community with current memberships in: Social Investment Organization (SIO), The International Corporate Governance Network (ICGN,) Carbon Disclosure Project (CDP) and CDP Water, Canadian Coalition of Good Governance (CCGG) and the Pension Investment Association of Canada (PIAC).

9.0 Conclusion and Implications

RI is evolving globally and is now considered mainstream in developed countries, as evidenced by the upward trajectory of UNPRI membership, growing public demand for RI, and a fairly compelling business case for RI which is substantiated by a growing number of academic studies. RI is quickly becoming a competitive advantage for IM's, not just from a reputational perspective but from the intrinsic risk-adjusted value of the investments themselves. IM's in Canada are increasingly finding their collective voice as they collaborate on engagements and on requests for feedback to proposed changes to regulations. IM's thus have a key advocacy role to play in Canada and globally, to promote shareholder rights and to improve their respective regulatory and proxy voting systems.

AIMCo's '5 pillars' approach to RI offers significant value to clients, as it fully aligns with PRI's aspirational principles by incorporating ESG factors into investment analysis, reducing risk, improving corporate governance and contributing to long-term investment returns. AIMCo is focused on making a positive impact on investee firms' corporate governance, and will continue to focus on engagement, to improve alpha, decrease beta, and protect our investments.

FOOTNOTES

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