PALOS

Weekly Commentary

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CONTENTS

ESG and Responsible Investing
Part 2: Environmental - The "E" in ESG 1

Palos Funds vs. Benchmarks (Total Returns) 3

Disclaimer & Contacts 4

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ESG and Responsible Investing
Part 2: Environmental - The "E" in ESG

Environmental protection has been a hot topic since the mid-seventies, with most of the focus on air and water pollution, wildlife protection, forest conservation, and waste management. While these issues remain relevant today, the debate has grown to include climate change, carbon reduction, corporate accountability, and demands for governments to hasten change.

On the corporate front, managing the environmental impact of business activity is receiving warranted attention at the board level. While in the past, corporate actions to protect the environment were viewed as a 'nice thing to do', the ESG movement is demanding more of a 'must do' mentality. The days when corporations paid marginal attention to the environment are gone. In today's world, ignoring environmental issues presents tangible risks.

The first is ***financial risk***. Companies that show willingness to embrace environmental considerations and manage their resource needs responsibly are likely to be viewed favorably by investors and creditors. For example, effective management of environmental practices reduces the risk of suffering monetary damages from litigation and punitive regulatory sanctions. We've seen countless examples of environmental accidents carrying serious financial ramifications. Oil spills in the Gulf of Mexico and the Exxon Valdez catastrophe come to mind and corrective measures were costly.

Operational risk refers to the perpetual hazards that all businesses face in their daily activities. At the forefront is the threat that climate change poses to our planet. Many view the sharp rise in severe weather, droughts, flooding, and wildfires as serious long-term threats. The increasing frequency of weather-related incidents and the scale of property damage is likely to persist. We all remember the human suffering and physical devastation to U.S. Gulf Coast refineries and infrastructure from Hurricanes Katrina and Harvey. Disruption to local economies and commercial supply chains was long lasting, not to mention the widespread property destruction and cost of reparations.

Companies that choose to neglect ESG can face ***reputational risk***. We recognize that investor goals and mandates are diverse. Some may prioritize human capital or child labour issues over the environment. Regardless, the pressure is on for institutional investors to pay heed. For heavy carbon producers like the oil patch, the implications are significant. In recent conversations, we're hearing of increased commitments from Canadian producers to advance the development and implementation of carbon reducing technologies. While innovation presents an opportunity to boost a company's reputation and reduce risk, it can also be costly. But there's little choice. Oil will continue to be viewed with disdain and skepticism unless tangible steps are taken towards reducing the carbon footprint.

ESG remains in its early stages. Many challenges persist with regards to verifiable reporting standards, transparency, enforceability, and a global consensus for coordinated action. While European nations are pioneers, the current U.S. administration seems to lack the will and poorer nations lack the resources. Nevertheless, we remain steadfast in our view that despite its limitations, an assessment of environmental risk has value and will aid in alerting us to potential threats, as well as identifying investment opportunities.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$7.62	-3.21%
Palos Equity Income Fund - RRSP	PAL101	$5.47	-1.85%
Palos Merchant Fund L.P. (Dec 31, 2019) [2]	PAL500	$1.71	20.15%
Palos WP Growth Fund - RRSP	PAL210	$8.85	21.36%
Palos-Mitchell Alpha Fund [3]	PAL300	$8.95	-13.39%
S&P TSX Composite (Total Return with dividends reinvested)			-2.63%
S&P 500 (Total Return with dividends reinvested)			5.12%
S&P TSX Venture (Total Return with dividends reinvested)			22.98%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			0.70%
Canadian Government 10-Year			0.57%
Crude Oil Spot			US $37.05
Gold Spot			US $1900.20
US Gov't10-Year/Moody BAA Corp. Spread			275 bps
USD/CAD Exchange Rate Spot			US $0.7514

[1] Period ending October 2, 2020. Data extracted from Bloomberg
[2] Fund is priced annually
[3] Fund is priced weekly on Tuesdays

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