PALOS

Weekly Commentary

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By Charles Marleau CIM® and William Mitchell CIM®

ESG and Responsible Investing
Part 4: Governance issues - The "G" in ESG

Corporate governance refers to the system of rules, decision making processes, and internal guidelines that are intended to define the rules by which a company operates. Over the last 20 years we've heard numerous stories where poor corporate behaviour has led to catastrophic failure. Headlines of accounting scandals, fraudulent activity, and misappropriation were far too common and, in many cases, the consequences for stakeholders were severe. Accounting irregularities at WorldCom (2001), fraudulent activity involving undisclosed losses at Enron (2001), and the notorious collapse of Lehman Brothers (2008) are a few examples of poor governance.

Ultimate responsibility for good corporate behaviour begins with the Board of Directors. Holding the most powerful positions within a corporation, board members carry the duty and responsibility of ensuring that good behaviour is enshrined. The process begins with understanding and identifying weaknesses, a plan of action, and implementing a system of rules designed to guide the process. To be successful this process must address principles like clarity, competence, transparency, the rule of law, and a framework for oversight.

Oversight is critical. Senior managers who 'hold the power' often carry responsibilities for the day-to-day operations. It goes without saying that maximizing the value of a company is important to managers, employees, and shareholders alike. This can blur the lines between what's "good for the company" and what's "good for society". Thus, independent oversight becomes an important tool for assuring that governance remains focused on stakeholder priorities. Independent board members who have a mandate to hold internal management in check can elevate the standards of good conduct and reduce the potential for conflicts of interest to arise.

As the ESG theme grows, corporate governance has evolved to become an important criterion in the decision-making process. Investors are demanding greater attention be paid to issues like executive compensation, risk control, management incentives/remuneration, and the board nomination process. To address these issues more companies have created formal committees that bear the responsibility for monitoring, evaluating, and reporting their findings to the board level. Taking this one step further, full public transparency is viewed positively by those who hold are stakeholders and beneficiaries. This includes employees, customers, regulators, communities, and investors.

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For executives who act detrimentally or ignore the ramifications of poor corporate behaviour, the consequences can be severe. Fraudulent behavior at Enron and WorldCom resulted in executive imprisonment and insolvencies. Employees, shareholders, and related businesses paid a heavy price. Reputational damage to financial markets and capital formation was significant. The latter demonstrates that poor governance entails financial risk as well as operational risk. Companies with strong reputations will attract and retain higher quality employees, customers, and investors – an obvious benefit to long-term sustainability and enterprise value creation.

In our past three issues we've written about the growing importance that ESG investing holds in the investment evaluation process. Next week, we'll look at the challenges that ESG faces with regards to reporting, transparency, and standardization.

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Upcoming Special Event:

The Department of Economics and the Faculty of Social Sciences at the University of Ottawa invite you to the Marleau Lecture Series on Economic and Monetary Policy. Please join our virtual workshop "Digital Currency and Monetary Policy" to discuss the design and consequences of a central bank digital currency. The keynote speaker will be Professor Fernández-Villaverde (University of Pennsylvania, NBER and CEPR). In his presentation, Professor Fernández-Villaverde will build on his recent research, which is featured in *Cryptocurrencies: A Crash Course in Digital Monetary Economics* and *Central Bank Digital Currency: Central Banking for All?*

http://secure.campaigner.com/csb/Public/show/ch5q-2bbbz2--rxk3c-5ke7znj7#

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$7.79	0.03%
Palos Equity Income Fund - RRSP	PAL101	$5.70	1.21%
Palos Merchant Fund L.P. (Dec 31, 2019) [2]	PAL500	$1.71	20.15%
Palos WP Growth Fund - RRSP	PAL210	$10.09	31.74%
Palos-Mitchell Alpha Fund [3]	PAL300	$9.71	-6.39%
S&P TSX Composite (Total Return with dividends reinvested)			-1.07%
S&P 500 (Total Return with dividends reinvested)			9.44%
S&P TSX Venture (Total Return with dividends reinvested)			25.88%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			0.75%
Canadian Government 10-Year			0.58%
Crude Oil Spot			US $40.88
Gold Spot			US $1903.20
US Gov't10-Year/Moody BAA Corp. Spread			266 bps
USD/CAD Exchange Rate Spot			US $0.7581

[1] *Period ending October 16, 2020. Data extracted from Bloomberg*
[2] *Fund is priced annually*
[3] *Fund is priced weekly on Tuesdays*

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