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PALOS

Weekly Commentary

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By Charles Marleau CIM® and William Mitchell CIM®

ESG and Responsible Investing
Part 6: ESG – Do socially responsible mandates lead to diminished returns?

In recent editions of our weekly newsletter, we've discussed the evolution of the ESG movement, each of the three components that make up ESG (environment, social, governance), and the challenges facing the development universally accepted regulatory framework. We've also highlighted how the ESG movement continues to gather momentum.

For individual companies, investing to reduce their environmental impact can be costly in terms of the human and financial capital required. ESG costs money and as such, conventional wisdom should lead us to conclude that companies choosing to allocate a greater amount of financial resources to ESG should underperform those companies that that do not. But is this truly the case? Does socially responsible behavior come at the cost of diminished financial returns? Or can an argument be made that the cost or ignoring ESG poses a greater risk.

For example, as policy makers worldwide accelerate efforts to implement stricter regulations on carbon emissions, the spotlight will be focused on the oil industry. The oil and gas exploration & production sector is the perfect example of a sector facing pressure to neutralize greenhouse gas emissions. In response to greater scrutiny, oil majors like BP and Royal Dutch Shell have recently announced strategies that promise to make sustainability and transparent ESG reporting a priority. Additional initiatives aim to replace carbon intensive production with technologies to decarbonize the industry and advance renewables. Companies that shirk their ESG responsibilities are likely to suffer consequences.

While images of 'dirty oil' will remain a headwind for oil, the reality is that global demand for energy is projected to grow and fossil fuels are expected to remain a significant contributor to satisfying energy needs. In response to criticism and acknowledging the powerful forces behind the climate change debate, the oil industry has recognized its need to adopt ESG principles. These measures are viewed as a necessary response to protect the long-term viability and protect the market values of their enterprises. Investors and policy makers have spoken loud and clear; those who ignore or refuse to adapt to ESG demands will do so at their own peril.

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Institutional investors that use ESG screening as part of their investment analysis include some of the world's largest pension funds and endowments. This is evidenced by the growing number of ESG investment products coming to market. As any economist knows, demand is one of the two principal drivers of price, with supply being the other. Sheer demand for positively screened investment options should continue to drive price.

While the screening process remains imperfect and largely based on subjective analysis, the number of investors that are demanding an ESG conscious approach continues to grow. In response, we're witnessing astounding growth in the sheer number of ESG themed investment products coming to market. Despite the absence of reliable data, the common belief that sustainable investing produces lower returns than conventional strategies is currently being questioned. Central banks are supporting the issuance of 'green bonds' as a means for transitioning to a greener economy.

We conclude our series on ESG investing with the following thoughts and observations. The ESG movement is rapidly evolving and ESG themes are increasing in popularity, particularly among younger investors. There are shortcomings. There remains an absence of uniform rules, consistent data, and standardized reporting. This renders ESG assessment and screening processes as unsophisticated and based on best effort judgement.

Regardless, we believe the ESG movement is here to stay and this reinforces our belief that ESG screening and performance evaluation must be included in the fundamental analysis and security selection process. Analysis should consider a process of ***negative screening***, which is designed to constrain risk by eliminating investment consideration in any company with poor record on ESG. On the flip side, ***positive screening*** can be useful in identifying companies who either score well or have indicated a commitment to improve. Companies that score well will be viewed favorably and this will increase their likelihood for inclusion in ESG themed investment products like Exchange Traded Funds (ETFs).

Investors should also consider that companies that do not address ESG may face challenges on legal and regulatory matters, particularly given the assumption that ESG reporting will eventually see regulatory standardization. Companies labelled as 'bad actors' can face consequences. ***Reputational damage*** can be costly and include litigation on matters including environmental impact, labour practices, and diversity. Low ESG scores can negatively influence capital and talent attraction, employee retention, and productivity.

The bottom line, while ESG and sustainable investing has a long way to go, we believe it is prudent to include ESG metrics in any comprehensive analysis. To do otherwise simply opens the door to elevated risk.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$7.49	-3.87%
Palos Equity Income Fund - RRSP	PAL101	$5.50	-2.28%
Palos Merchant Fund L.P. (Dec 31, 2019) [2]	PAL500	$1.71	20.15%
Palos WP Growth Fund - RRSP	PAL210	$9.93	29.72%
Palos-Mitchell Alpha Fund [3]	PAL300	$9.62	-7.22%
S&P TSX Composite (Total Return with dividends reinvested)			-6.11%
S&P 500 (Total Return with dividends reinvested)			2.76%
S&P TSX Venture (Total Return with dividends reinvested)			18.69%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			0.87%
Canadian Government 10-Year			0.66%
Crude Oil Spot			US $35.79
Gold Spot			US $1879.90
US Gov't10-Year/Moody BAA Corp. Spread			264 bps
USD/CAD Exchange Rate Spot			US $0.7508

[1] *Period ending October 30, 2020. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

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Disclaimer:

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca