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Charting our own green path
DM's approach to ESG evaluation

Background

Though interest in Environmental, Social, & Governance (ESG) oriented investing had experienced rapid growth in the decade prior to 2020, there was some fear that the challenges presented by the pandemic would derail this momentum. In fact, quite the opposite occurred, with the covid crisis providing individuals with a forceful reminder of the interconnection between our health, safety, and prosperity and the condition of our surroundings.

At the same time, prolific and widely broadcast cases of racial bias and minority mistreatment in the US and Canada sharpened our collective resolve to hold governments, law enforcement, and corporations to account for their actions. As a result of these developments, demand for social and environmental awareness in investment management has never been higher and seems likely to continue its growth.

Current ESG investment backdrop

When DM set out to add ESG evaluation to our analytical process, we first examined existing infrastructure and practices. For the most part, investment managers rely on third party rating agencies to assess the social and sustainability attributes of their portfolios and then adjust holdings accordingly, with in-house analysis in the space relatively limited.

In examining this common approach, however, we identified several shortcomings, not the least of which is the absence of a common set of standards as to what makes a business sustainable. This ambiguity, combined with the significant marketing appeal of ESG, had the potential to encourage "green-washing" of investment practices so that sustainability analysis is essentially reduced to a box-ticking exercise, instead of a catalyst for true progress and change.

Why we elected to build our own ESG process

Beyond the considerations outlined above, there were four key factors that drove us to establish a proprietary ESG evaluation framework, rather than outsourcing this work:

1. DM built its reputation on in-house research
For more than 20 years, we've managed all of our portfolio mandates internally and so turning over ESG analysis to a third party would have been a departure. As well, because our investment process puts significant emphasis on interaction with executive teams, we knew that investigating the qualitative and cultural aspects of each company's ESG approach would dovetail naturally with existing work.

2. ESG data is spotty and coverage still limited
Because sustainability analysis is so new, data is often incomplete for individual companies and may not even exist for others. This is especially true for smaller and mid-sized companies, which meant that relying exclusively on external ratings would leave significant gaps in our portfolios.

3. Low consistency across ESG rating agencies
During our due diligence, we noticed that there was often wide discrepancy between how two agencies rated the same company. This inconsistency raised questions about the robustness of the existing rating framework and made us even more wary about attaching our name to the evaluation work of others. As well, the divergence raised the possibility that investment managers might "shop" for ratings – in other words devote their ESG efforts to finding assessments that supported their holdings, rather than pressing for meaningful change in the companies they own.

4. Factor weights may cause unwanted distortions
Though "Environment" may be the first criteria that people think of when they hear ESG, a company's rating may be more influenced by the other two

standards. For investors most concerned with climate change and the wellbeing of the natural world, for example, this characteristic may lead to confusion with ESG scores and flawed decision making. A stark example of this possibility can be found in one agency's ESG rating for Carnival Corp., the major cruise line operator which also happens to be a serial bad actor when it comes to the environment.

In 2017, Carnival was found guilty in US Federal Court of several offenses, including the dumping of oil-contaminated waste and sewage into the ocean and falsifying official logs in order to conceal the discharges. For these infractions, the company was put on probation for 5 years and hit with a $40m fine (the largest ever for deliberate vessel pollution). In 2019, however, the hospitality giant was caught in the act again and slapped with another $20m in penalties.

When we checked Carnival's ESG risk rating at one of major agencies, we saw that was 23.9 out of 100. This sounds like an appropriately punitive score, until one realizes that the firm's evaluation scale is inverted, so that 0 is best and 100 is worst. To put this grade in more familiar terms, it would be the equivalent of getting 76% on an exam – *not exceptional, but certainly not a fail*.

The only explanation for this relatively agreeable rating is that the company's scores in the "S" and "G" components must be great enough to overcome its abysmal record in "E". If you belong to an Indigenous community located in a Nova Scotia harbour or happen to live on the BC coast, however, you're likely far less concerned with Carnival's hiring practices or boardroom diversity than you are with how they treat your air, water, and shoreline. To best reflect the interests of our clients, therefore, we decided that our ESG process should include its own factor weightings, rather than defaulting to the judgement of others.

DM's ESG evaluation framework

In constructing our ESG approach, we divided our analytical work into four key components:

1. **Determine Materiality**

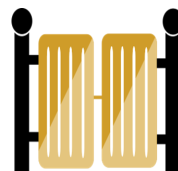
ESG factors are assessed to determine which are most relevant for each portfolio holding. In the preceding example, our weights would tilt more heavily toward environmental considerations than they would for a bank or tech company.

2. **Gather Data**

As with the other aspects of our investment process, meetings with company management provide an important source of ESG information. This insight is then augmented with data from relevant publications, such as Corporate Social Responsibility (CSR) reports.

3. **Evaluate & Score**

Once ESG data has been gathered and organized, 30 different metrics are graded based on their trend (improving/neutral/deteriorating). In our evaluation, we take into account the company's internal targets, its history of ethical behaviour, and the willingness of management to address and solve issues in a transparent way.



4. **Aggregate & Screen**

Finally, we enter our scores for each metric into a dashboard matrix which allows us to rank each position within the portfolio and track its progress over time. The output from this analysis then becomes one of the five qualitative gating factors that we use to screen holdings before we begin our quantitative analytical work.

Evaluation to action

From the outset, we decided that including ESG analysis in our investment process would be only as worthwhile as what we did with it. Rather than simply observing the companies in DM portfolios and cataloguing their sustainability conduct, we instead wanted to use our insight to influence corporate behaviour and management responsiveness to ESG issues. We meet this goal in three ways:

Engagement

As mentioned above, management consultation is an integral part of our investment process – in *support of our Canadian equity mandates, for example, we conduct more than 100 meetings with executive teams each year*. These interactions not only provide the best opportunity for our analysts to assess a company's ESG strength and commitment, they also allow us the chance to influence sustainability goals and encourage their fulfillment.

Election

When we're not in front of corporate management, we frequently use our shareholder votes to endorse ESG-positive initiatives and executives and reject those which are not. Though DM is not the largest firm in the asset management space, by pooling our voting power with that of other like-minded managers and institutions we can create meaningful momentum for change.

Allocation

As stewards of significant capital, we can also vote with the dollars we manage. One way to express our views on ESG and how companies are performing against sustainability expectations is through the securities we include in our portfolios and those which we avoid. As our reputation for leadership in the space grows, we are confident that the impact of our allocation decisions will also expand over time.

Sustainability as a signal

Not long after implementing our ESG evaluation framework, we realized that including it in our investment process would deepen our understanding of the companies we own and their leadership cultures. The sincerity and depth of a management team's response to sustainability demands can reveal much about its ability to address changing business conditions in general and how it will handle other important tests. Those who approach this area with openness and transparency (*in contrast to the executive group at Carnival*) bolster our confidence in their communications and in their willingness to face corporate and industry challenges head-on.

Likewise, companies which encourage diversity wind up with a wider range of perspectives at the decision-making table, which inevitably leads to better outcomes for both the business and the community in which it operates. Finally, firms that proactively consult and partner with their Indigenous neighbours sow the seeds of long term stability and value growth. For all of these reasons, the inclusion of ESG analysis in our investment process has made us better investors and more effective stewards of client wealth.