Vancity Investment Management

RESPONSIBLE INVESTING NEWSLETTER – JULY 2018

Vancity Investment Management

How does our carbon footprint measure up?

MANAGING FINANCIAL RISKS FROM CLIMATE CHANGE

From the early nineteenth century up to the present day, fossil fuels such as coal, oil and gas have played a catalyzing role in the development of modern industrial society. At the same time, greenhouse gas emissions generated from the use of these energy sources are the leading cause of human-induced climate change. Because of the global nature of climate impacts, all areas of the planet are affected, regardless of where emissions are produced. The effects of environmental degradation touch virtually every area of human activity, including the global economy and financial markets. Left unchecked, the risks associated with climate change have the potential to cause significant economic stress.

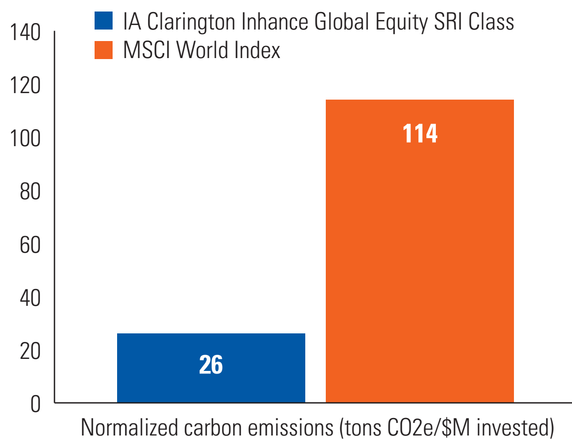
In recognition of the potential for climate risks to disrupt financial markets, G7 finance ministers and central banks have established the Task Force on Climate-Related Financial Disclosure (TCFD). The TCFD's main function is to recommend ways of preventing climate risks from becoming systemic and pervasive. Key recommendations of the TCFD focus on companies providing disclosure on governance structure, strategies, risk management processes, targets and metrics in relation to climate change. One aspect of the recommendations that Vancity Investment Management (VCIM) has focused on recently is metrics; specifically, quantifying a fund's exposure to climate risk.

MEASURING A FUND'S CARBON FOOTPRINT

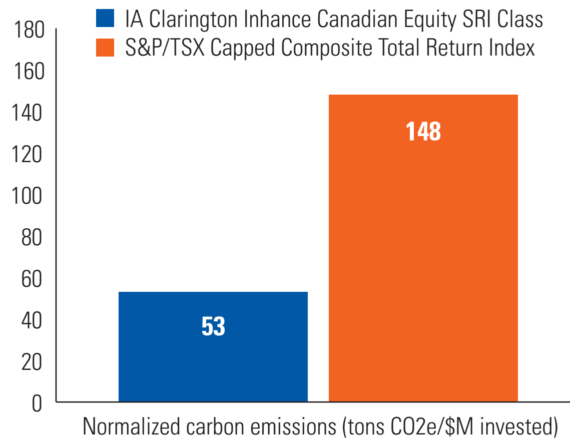
Key to assessing a fund's climate risk exposure is an estimate of its carbon footprint. The estimate is based on the direct and indirect emissions of each company owned by the fund. Direct emissions are caused by company operations, such as burning natural gas to heat facilities. Indirect emissions are generated in the production of goods and services used by the company, such as electricity purchased from a utility. The combined total is the company's carbon footprint. Each company's emissions are then allocated on a per share basis. The carbon footprint of the fund depends on the number of shares it owns. The same method can be used to estimate the footprint of the fund's benchmark index, allowing investors to examine the overall exposure of a fund to climate risk relative to the broader market.

VCIM recently undertook a comparison of IA Clarington Inhance Global Equity SRI Class and IA Clarington Inhance Canadian Equity SRI Class to each fund's benchmark using a carbon estimation framework developed by MSCI ESG Research LLC.[1]

Based on the MSCI framework, VCIM estimates that investing $1 million across the companies in IA Clarington Inhance Global Equity SRI Class results in a carbon footprint of approximately 26 tons of greenhouse gas emissions, while investing $1 million in the benchmark MSCI World Index results in 114 tons. That translates into an emissions profile for the Fund that's 77% lower than the benchmark.



Source: VCIM, using tools developed by MSCI ESG Research LLC, as at June 30, 2018. Data for IA Clarington Inhance Global Equity SRI Class covers 97% of the companies in the Fund; data for the MSCI World Index covers 99.8% of the companies in the index.



Source: VCIM, using tools developed by MSCI ESG Research LLC, as at June 30, 2018. Data for IA Clarington Inhance Canadian Equity SRI Class covers 96% of the companies in the Fund; data for the S&P/TSX Composite Index covers 95% of the companies in the index.

Investing $1 million across the companies in IA Clarington Inhance Canadian Equity SRI Class results in a carbon footprint of approximately 53 tons of greenhouse gas emissions, while the same investment in the benchmark S&P/TSX Composite Index results in 148 tons. In this case, the emissions profile for the Fund is 64% lower than the benchmark.

The carbon footprint analysis demonstrates that VCIM's divestment and decarbonization strategies have succeeded in reducing overall climate risk exposure. While the complete elimination of systemic climate risk is not achievable, reducing the specific risk associated with each company provides some assurance that investment decision makers are endeavoring to minimize each fund's potential losses as climate policy, regulations and financial costs materialize. We look forward to applying the carbon footprint analysis to IA Clarington Inhance Bond SRI Fund, IA Clarington Inhance Monthly Income SRI Fund and the Inhance Portfolios as tools for estimating fixed-income exposure are developed.

Dermot Foley, CFA, is Portfolio Manager – ESG Analysis, at Vancity Investment Management Ltd.

Is it in the numbers yet?

In the heat of second quarter earnings season, investors can be driven to distraction about upcoming summer holidays. One may consider the beach, a chaise lounge, sunscreen and a frosty beverage of your choosing. It's a perfect opportunity to contemplate what should be the leading item on the wall of worry list that markets must climb in 2018. My list has trade and an escalating cycle of protectionist measures as top risks to equity market performance.

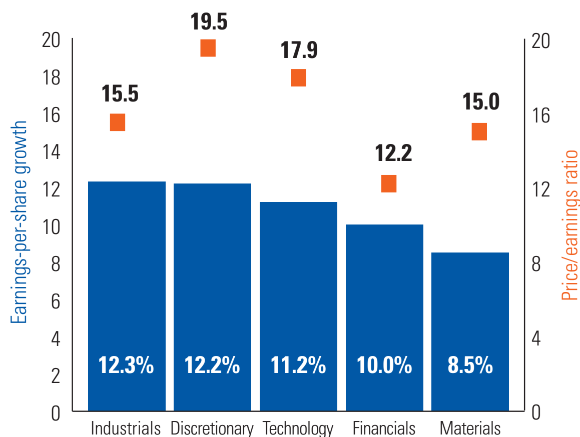
When you set aside the noise of political gaffes, rhetoric and bipartisan divisiveness, the impact of imposing tariffs and battling trade disputes stands out as a meaningful risk to equity market performance and the current synchronized nature of global economic growth.

Some strategists suggest that investors have grown accustomed to accommodative policy actions, such as the tax-driven fiscal stimulus implemented by the U.S. in late 2017, which has supported stock market performance. Complacency assumes "it is all just going to work out if a concession or two is made by each side and everyone just meets in the middle ground." However, trade policy is never as simple as solving for trade deficits through negotiation. Disputes can quickly lead to escalating retaliatory tariffs and unintended consequences that can impact financial markets.

Protectionist measures impede the normal flow of goods around the globe and introduce risk to the sentiment of decision makers at the centre of corporate investment. Companies may have to contend with increased shortfall risk to both their revenue and cost lines of the income statement. Higher tariffs mean companies may sell fewer goods overseas or absorb a margin hit to maintain volumes. In addition, tariffs on the intermediate goods necessary for production translate to higher costs for manufacturers like Coca-Cola, which could lead these companies to increase prices.

To be fair, it is not all doom and gloom on the tariff and trade front. Recently, things have improved on two of the three trade war fronts – the U.S and European Union, and NAFTA. Although we are a tweet away from it changing, the European Union and the U.S. have agreed to a standstill on new tariffs and have launched talks to eliminate existing barriers and subsidies. Canada has not yet been brought into the fold, but the government appears ready to come to the table. The proverbial elephant in the room that still needs to be addressed is China. Perhaps a united front for North America and the European Union could be more successful in convincing China to move to a more open and "fair" market. However, strategists caution that the Chinese have yet to put forward a plan that convincingly opens its market to foreigners. Time will tell.

Where do we see opportunities amidst these trade concerns? The numbers say it may be in industrials. The price-to-earnings ratios of the U.S. industrials sector have contracted approximately 20% from the peak levels we saw in 2017. This makes sense in the face of trade concerns, where company supply chains are global and the level of international sales is naturally high for large, multinational firms. In the later stages of an economic cycle, cyclical sectors tend to outperform, and industrials are no exception, with top-ranked 2019 consensus earnings expectations.



Source: Bloomberg, as at July 26, 2018. Based on 2019 consensus estimates for earnings per share.

A reasonable sector valuation post-multiple compression and healthy expectations for future earnings growth may support a view that industrials stocks could see the strongest rebound from current levels if global trade concerns start to see the glimmer of a resolution.

There's still time to enjoy the sun and surf, but we expect a continuation in the fall of the bumpy ride 2018 has brought us thus far.

Andrew Simpson, CFA, is Director – Investment Management, at Vancity Investment Management Ltd.

DEFINITION OF TERMS

Cyclical sectors – Sectors whose performance is impacted by economic expansions and contractions.

Decarbonization – Refers to the reduction of a portfolio's carbon emissions profile.

Divestment – Refers to the elimination of investments in companies with specific characteristics.

Earnings per share – A company's profits per share of common stock outstanding.

Fiscal stimulus – A government action or policy designed to stimulate economic activity.

Margin – Refers to a company's profits.

Multiple – A ratio that measures a company's financial health and indicates how much investors are willing to pay for a security.

Multiple compression – A reduction in a company's multiple.

Price-to-earnings ratio – An important stock valuation metric that measures the price of a company's shares relative to per-share earnings.

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