CAIM - ESG White Paper

Defining ESG

The investment management industry has had a surge of interest in the concept of ESG investing. This has been driven by individual investor desires to incorporate 'responsible' factors of **Environmental (E), Social (S), and Governance (G)** into their investment decisions. While this is not a new concept, the nomenclature and process has changed over the years. Terms such as 'Socially Responsible Investing' (SRI), Sustainable Investing (SI) Corporate Social Responsibility (CSR) and 'Impact Investing' have also been used interchangeably, but our experience is that they are either too specific (SRI), too vague (CSR, SI) or not specific at all (Impact). In fact, SRI has been more exclusionary in screening out bad companies (negative screening). A**t CAIM, we have concluded the more proactive ESG is the broadest term that captures the discipline we aim to accomplish for our investors, while in finding good investment opportunities.**

We also note that the concept of 'impact' has been getting some press suggesting a tradeoff with financial returns to achieve social and environmental values. But that is quite the opposite of what we hope to hope to achieve with our ESG system – **we will not sacrifice financial returns. We simply believe there are enough investment options to achieve superior returns while achieving our ESG goals.**

Why Bother? Does ESG Add Value?

Yes – More Investors Want It. Simply put, wealth management clients are increasingly asking for more of a socially responsible bent to their investing – they want to 'feel good' about their investments, and seek to align them with their values.

In fact, 'Retail' investors have surged to 25% of money being invested with an ESG bent, up sharply over the last several years. It has also become clear that the Millennial generation cares much more about ESG factors in their concern about the future. With over $40 trillion in wealth now beginning to transfer from the Baby Boomers to this generation, we fully expect ESG to become increasingly important to their investment portfolios as well. In addition, Women have polled much higher than Men in caring about ESG – and 70% of widows tend to change advisors and/or investments.

And ESG Investing Works. As a result, ESG funds are clearly on the increase. More than 60 new such funds were launched this past year, and more than $10 trillion is now invested globally using ESG criteria. And such 'responsible' investing is not unrelated to investment returns. **We believe ESG can create additional alpha,** while mitigating risks which can impair assets and increase a company's cost of capital. In fact, the underlying principles of ESG are not really new, as they largely always been part of our fundamental analysis.

Supported by Studies. Studies have shown companies with high ESG scores can have positive performance advantages. *Deutsche Asset Management* ran a comprehensive review of many ESG studies, and concluded that 90% of such studies showed a positive or at worst neutral relationship between ESG investing and financial performance, across a number of asset classes. Also, *Oxford University* along with *Arabesque Partners* found that nearly 90% of studies suggest that ESG practices drive operational performance. **Most importantly, this review found that 80% of the studies indicate stock price performance is positively correlated with good sustainability practices.** Finally, *Calvert* has measured the relative performance of the MSCI ESG leaders, and has found that since 1993 performance has been double the growth rate of the laggards. Even accounting for survivor bias, this is a significant finding.

On the question of causality of improved profitability, we wondered if more profitable companies do better on ESG issues because they can more afford to. In this regard, *JUST Capital* ran such data with a Fama-French model and concluded that some of the alpha can be contributed to ESG-oriented business behaviors. While this is only one study, we believe it suggests that ESG is associated with a more alpha outcome.

Simple Supply & Demand → Higher Prices. In our view, it is a simple case of supply and demand. If over time, investors want to increasingly own companies with better ESG performance, then t**hese stocks will rise more than those with lower ESG measures**. Simply put, if more investors start doing it, the market will react – 'more buyers than sellers' means outperformance.

A Virtuous Cycle? Further, we see a 'virtuous cycle' evolving – as stock prices are increasingly driven by ESG factors, **managements should respond with actions that increase their own ESG scores further**. Put another way, it should become increasingly difficult for managements and boards to avoid ESG principles, especially with increasing shareholder proposals and proxy votes related to ESG driving more accountability in the boardroom. And as such a 'virtuous cycle' perpetuates itself, we believe it is essential to be 'ahead of the curve' in our investment portfolio construction for our clients.

3-Year Numbers Should Help. Finally, our experience with asset allocation is that the longer the track record, the more likely funds can attract more capital. We note that with many of ESG funds created in the last several years, we are now coming into a period where 3-year performance histories are just being completed. In both equity and other asset classes, that has been a critical time period to illustrate track records for managers. In fact, most foundations and endowments will not consider managers that lack a 3-year track record. As such, we expect consultants, advisors, and other third-party allocators to **accelerate capital into the ESG space** over the next couple of years.

The Confusing Measurement System

Started With SASB. The Sustainability Accounting Standards Board (SASB) was among the first to create disclosure standards for financially material sustainability issues that are relevant to each industry sector and companies within that sector. Public companies are increasingly adopting such guides to focus disclosure efforts. Such disclosure helps provide key data to providers who are helping in the measurement systems.

Many Measurement Systems. The good news is that there are measurement systems that are becoming increasingly popular. The bad news is that there are several different systems, and they tend to not have a lot of correlation with each other. A recent *State Street* report cites over 100 data providers. There are not quite as many scoring systems, some of them proprietary, but the major companies with more popular scoring systems include *MSCI, Sustainalytics, CDP, Robeco(RepRisk)* among others, with have developed ranking systems to measure such factors. Each provider tends to weight the various inputs differently, as well as score them differently, so it is easy to see why there is no clear consensus in this area. In fact, a recent study by *Capital Group* found an only 0.24 correlation ratio between ESG data from *MSCI* and *Robeco*. Perhaps a good analogy is stock analyst ratings – but at the end of the day, some will be more right than others.

MSCI Fits Our Universe the Best. While the scoring discipline is rapidly evolving, we have now had the opportunity to study these various services, albeit over a short time span, in addition to changes over this time in the overall scores and with the three components (E, S, and G) of the scoring system. With particular respect to our subset of the stock universe that are **focused on dividends and growth of such dividends, we believe that the MSCI scoring system is the best match with our screening process** with our larger capitalization universe of stocks. MSCI has a longer track record and tends to be more global in its analysis, a good fit with our typically multi-national larger cap universe. In a plug for MSCI, we note that the company highlighted the risks of forest fires to PG&E a year before catastrophe led to the firm's bankruptcy.

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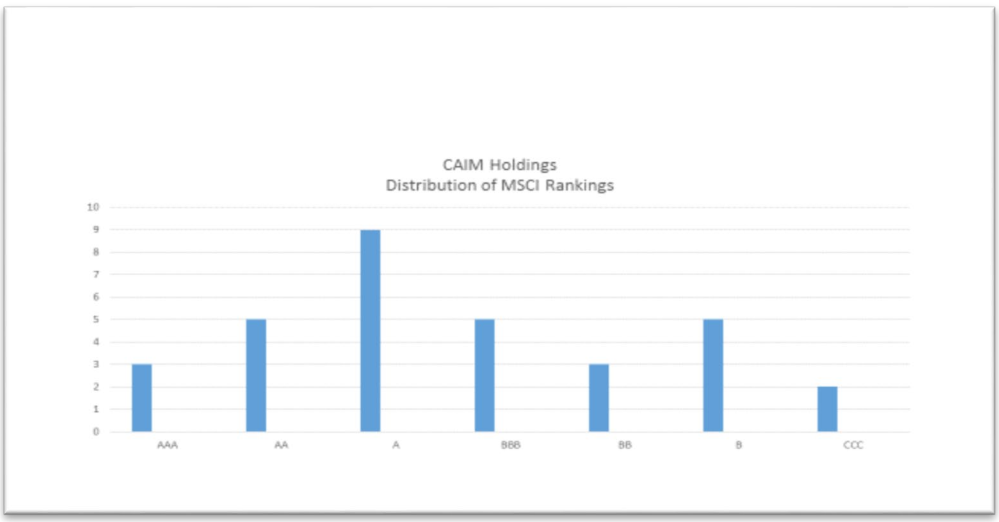
Our Portfolio Ranks Well Above Average. At CAIM, we combine our strict financial discipline with research from MSCI to identify companies committed to ESG principles and their positive impact on society. Our current portfolio is biased toward the best ESG ranking companies, keeping in mind that our diversification efforts do require us to be in some industry sectors that are not as well ranked as others. Nevertheless, as shown in the distribution below, **over two-thirds of our portfolio is ranked in the upper half of MSCI ranking**, BBB or above. We also have an affinity for this letter ranking system, as it tends to suggest comparison to long-running bond ranking systems from companies such as *S&P* and *Moody's*. In other words, it may be a 'language' that others may be willing to adopt due to familiarity. In summary, we believe our system helps allocate capital to those companies which have the most positive impact.



Other Evaluators. There are also some 'next gen' evaluators which are emerging, though we view them more as complementary to the more popular scoring systems than as a substitute. The Global Impact Investment Ratings System (GIIRS) is Impact measures in the private equity and venture capital communities, which is where many Environmental leaders were first incubated. The Global Investing Impact Network (GIIN) is more of an advocacy group than a scoring system, though it is gaining momentum among subscribers.

Key Fund-of-Funds Players. There are also intermediary fund management managers who aggregate RIA and manager capital in this space and allocate to the best ESG managers. Examples of leaders include *Silver Leaf Partners* in the institutional fund market and *Gitterman Wealth Management* in the high net worth market, which has implanted a SMART approach, an acronym for Sustainable Metrics Applied to Risk Tolerance. Finally, *Cornerstone Capital* not only has a broad spectrum, but also has introduced the innovative Access Impact Framework, which creates a 'heat map' which investors can view in colors for how money meets their goals instead of a numerical scale, which we view as very user friendly.

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ESG in the Context of the CAIM Dividend Growth Strategy

Of course, CAIM's primary focus is on owning the best companies that can pay superior dividends and have the financial power to grow those dividends at superior rates. However, we cannot own, and don't want to dilute our portfolio by owning, all the companies can fit that criteria. So **adding an ESG layer to our stock selection process helps us narrow our screening process further**, and as we believe these stocks will be increasingly in demand over the longer term, **we believe our approach will enhance outperformance**.

To this end, we focus on buying companies whose scores are above average, both relative to the market and relative to their peer group. We note that some industry sectors tend to score lower than others, particularly on the more absolute Environmental factor. As we still strive to diversify our portfolio across industry sectors, we don't want to completely ignore an S&P sector. In such case, we put more weight on the Social and Governance components, as well as consider the relative Environmental score within the industry sector.

We also look for companies with 'ESG Momentum'. Ranking systems have now been around long enough that one could see patterns or changes in scoring components. A company with would give it positive such momentum, which we intend to value as well, particularly for such companies in industry sectors that don't score as well overall. **A positive trend in such scoring will move that name up rapidly in our screen rankings. We call this 'ESG Momentum'.**

Finally, we note that some factors are more financially material than others with respect to a specific company. Since ultimately our mission is to achieve superior investment returns, **we have found that good Governance has the most direct impact on a company's financial returns**, while Environmental and Sustainability factors have a more indirect and longer term impact on returns. So **we put a particular emphasis on the 'G' scoring** in the MSCI component index, particularly as we believe popular perception on ESG is focused more on a 'Green' or 'anti-pollution' measures (E), so-called 'negative screening'.

In the remainder of this note, we provide more granularity on the detailed components of the ESG factors which we focus on at CAIM in our investment decisions. We believe such factors below are the most material to financial results.

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Environmental Factors

Unlike the Social and Governance components, not all of our companies have relevant environmental measures in the 'green' sense of the word, but even service-oriented companies have resources and consumption that need to be managed. At CAIM, Environmental Factors that are important to us include:

- Energy management
- Environmental impact of supply chain
- Environmental impact of products
- Management of water scarcity
- Waste management
- Carbon emissions
- Climate change & policies
- Resource scarcity
- Lowering climate-related risks
- Litigation & reputation

Social Factors

Social factors in essence are the most mature part of the ESG discipline, in that early adopters of ESG related investing tended to focus on social factors (SRI, CSR, etc.) In fact, **over 45% of the 395 shareholder proposals submitted over the last year at public company annual meetings were related to social causes.** At CAIM, Social factors that are important to us include:

- Product safety & ethics
- Security of sensitive consumer data
- Effective cybersecurity
- Supply chain human rights
- Supply chain transparency and audit
- Employee security
- Employee health & safety
- Lower worker safety fines
- Worker compensation
- Diversity and Gender pay equity
- Community relations/impact
- Political contributions

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Governance Factors

Historically corporate boards have tended to be self-perpetuating and less diverse, creating an insular culture. **The increase in proxy-based engagement and shareholder involvement has made great strides in improving governance in recent years.** Factors for Governance that are important to us at CAIM include:

- Board structure and gender diversity
- Independent director involvement
- Board refreshment policies
- Board oversight of sustainability
- Stakeholder accountability
- Business ethics
- Accounting policies & controls
- Including ESG scores & risk factors
- Voting rules and share structure
- Positive impact from proxy voting and engagement

More Information Available

We welcome your interest in the CAIM platform, and look forward to an opportunity to work with you in 'Dividend ESG' investing.

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