

MRI  
Best-In-Class  
**Environmental**  
Divestment EMISSIONS PRI  
CLEANTECH  
Renewable  
FOSSIL FREE  
IMPACT  
ENERGY  
OPERATIONS  
Thematic SRI  
CARBON FOOTPRINT  
MISSION ENGAGEMENT  
Positive Screening  
Water  
ESG  
GREEN BONDS  
Climate Bonds

# Task Force Report on **Sustainable** Investment Taxonomy

September 2016

Dear Reader,

The idea of sustainable investing has never been more popular, relevant, and important. Total global sustainable investments are currently estimated to exceed \$25 trillion. Yet the health of our planet and our quality of life may depend on our ability to allocate *even more* capital in thoughtful ways.

## **Su•stain•able: Involving methods that do not completely use up or destroy natural resources**

The very definition of “sustainable” invokes positive qualities and characteristics. But when it comes to marketing investment products, the term “sustainable” has been used so widely – in the titles of companies, organizations and investment products – that it is often unclear exactly what it means. This could be said for other labels that invoke images of investment thoughtfulness, moral consideration, and environmental superiority. Terms like “responsible investing” or “socially responsible investing” have become synonymous with sustainability.

The confusion extends generally throughout the entire sustainable investment space. Acronyms like ESG (Environmental, Social and Governance) are often confused with others like SRI (Socially Responsible Investing), MRI (Mission Related Investing), and RI (Responsible Investing). More importantly, ESG, which largely involves some type of investment screening process, is often confused with environmental, social or governance theme investing - a different investment discipline altogether.

As if this wasn't confusing enough, there is also an investment practice called ESG Integration, where ESG considerations are applied to all investments in both traditional funds and even some environmental and social themed funds.

Investors must also consider signatories to organizations like the UN Principles of Responsible investment (UNPRI) or the Carbon Disclosure Project (CDP). There are as many as 400 of these initiatives worldwide, all looking for investors' attention.

We set out to define the taxonomy of sustainable investing and propose a simple model to clarify sustainability labels, including those that are synonymous, and those that mean very different things. The report captures data and market perspectives from over 30 investment managers and industry leaders working in the sustainable investing world. At the same time we were careful not to identify the individual views of investment professionals interviewed, list funds, track records, predict performance, or discuss the impact attributes of various products.

Our hope is that the report will raise awareness of sustainable investing generally and stimulate discussion among investment managers, the media and investors about these labels and the differences in structure and strategies between portfolio allocations.

John Cook  
Task Force Secretary

## Brief History of Sustainable Investing

To understand the confusion between certain terms and definitions within the sustainable investing space, it is useful to understand the history of sustainable investing itself. Sustainable Investing has its origins among religious organizations in America. One of the first instances of this dates back to the 18<sup>th</sup> century when the Methodist church and Quakers prohibited their followers from investing in slavery, war, and sin industries (liquor, tobacco, gambling, etc.). The United Church continues to subject its investments to positive and negative screening, social impact analysis, and shareholder activism.

Sustainable Investing was largely focused on screening to avoid sin industries, up until the late 1960s. Since that time there has been a shift from purely religious motivations toward more secular issues. In the 1970s students opposing the Vietnam War asked their universities to divest from military contractors. In the 1980s there was a divestment movement targeting South Africa's apartheid policies. Academic institutions, pension funds, and others threatened to divest their assets in companies operating within the country.

Over the years concerns regarding the environment developed within the investing community, driven by incidents like the Exxon Valdez oil spill and the Bhopal Union Carbide plant disaster, as well as the growing concern regarding greenhouse gases and climate change. Eventually endowment funds, charities and other institutions began relating their allocation of capital within their investments back to their chosen missions, seeking greater alignment with their values. To cater to this growing demand, thematic investing was introduced involving investment strategies based on specific environmental and social themes.

In the early 1990s new investment products emerged that not only excluded particular sectors (negative screening) but also selected companies based on

superior environmental, social and governance characteristics (ESG positive screening). Demand for 3<sup>rd</sup> party ESG data has been growing steadily since the 1990s.

In addition to demand for data, there has been an increase of concerns about climate change and how to address this in relation to investment strategy. The focus on divestment from fossil fuels was launched into public light in 2007 by an environmental organization called 350.org started a successful global fossil fuel divestment campaign. The movement driven primarily by university students and faculty, and faith based organizations has already forced hundreds of pension plans to reconsider environmental risks related to climate change and the transitioning global energy complex. To date, hundreds of organizations around the world representing over \$3.4 trillion have already committed to a fossil fuel divestment program. That said, many more have either refused to divest outright or deflected pressure by changing investment policies to apply some form of ESG practices.

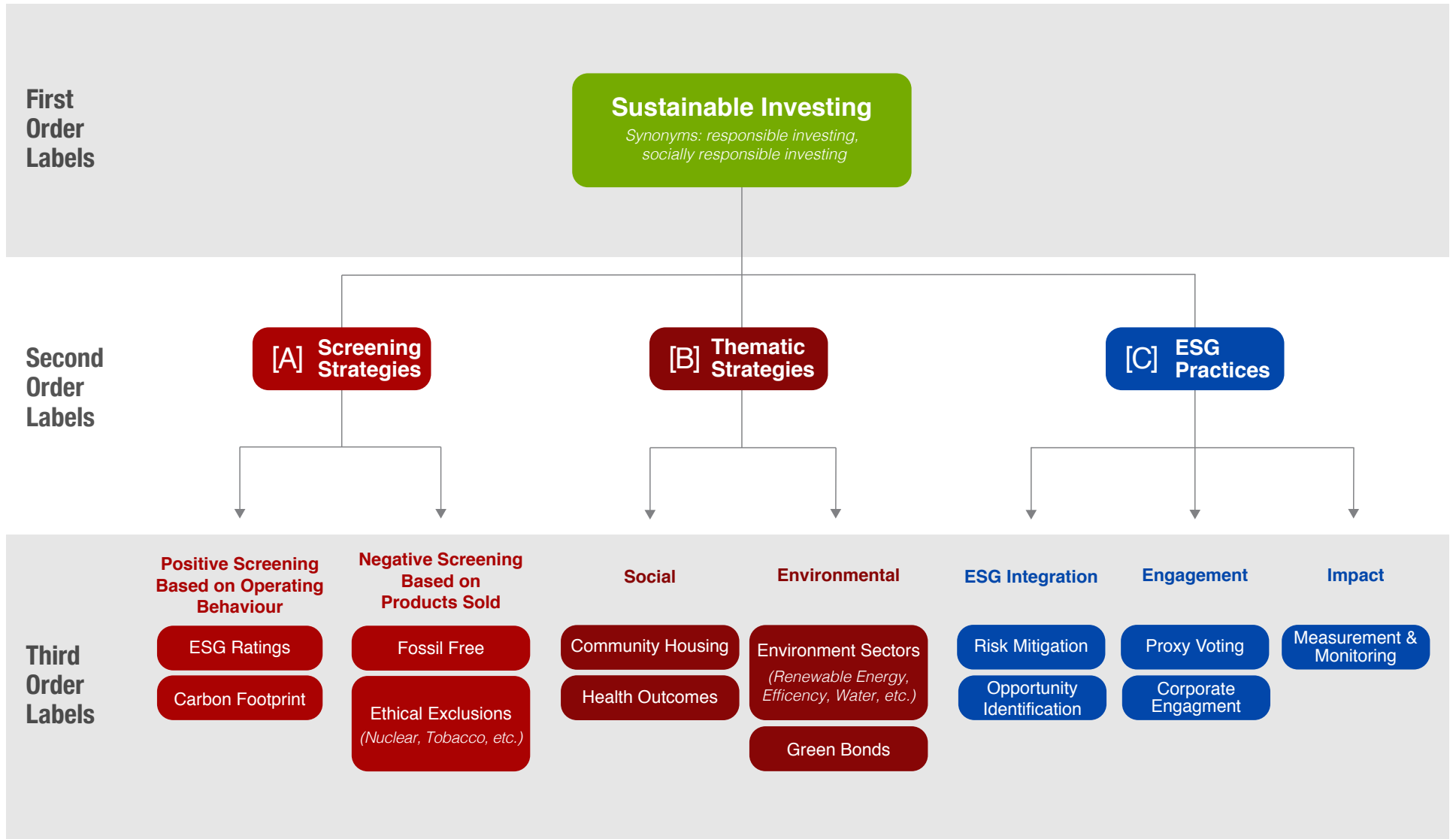
In the past five years, a new form of impact investing has taken root. A small group of investors has emerged seeking greater environmental and/or social change in addition to achieving financial returns. These investors by definition are looking for investments where both impact and investment performance can be measured. Impact investments include products like direct private equity, community housing bonds and climate bonds.

Another interesting development is the move to integrate ESG into *all* investment decisions. ESG Integration is currently being employed by even the most traditional investment managers as a way to identify new business risks, or to improve corporate behavior through direct engagement and shareholder activism.

From negative screening and exclusion in the 1960s to impact investing and ESG integration today, sustainable investing is likely to remain in a constant state of change.

# Proposed Taxonomy Model

We came to the conclusion that sustainable investment labels could generally be divided into three distinct orders.



## First-Order Labels

The Task Force agreed that broadest labels for this space were “Sustainable Investing”, “Responsible Investing” (RI) and “Socially Responsible Investing” (SRI). While it is possible to argue that these terms have had slightly different meanings historically, we concluded that these differences are currently non-material. As such, we concluded that “sustainable investing” is interchangeable with the terms “responsible investing” or “socially responsible investing”. These three terms all capture the ideas of environmental and social thoughtfulness, as well as longer-term perspectives. They also satisfy the average retail investor’s desire that their investments were being directed to a better place. We also agreed that these three terms do not mean much beyond a simplistic, generic nod to good.

***For the purpose of consistency we chose to use the term “sustainable investing” as the highest order label throughout this report.***

## Second-Order Labels

Our research and analysis guided our decision to separate sustainable investing into three second-order labels. Two distinct investment strategies: [A] Screening strategies, and [B] Thematic strategies based on environmental or social screening theses. The third second-order label [C] ESG Integration is not an investment strategy per se but an investment *practice*.

### [A] Screening Strategies

Screening strategies, as the name implies, utilize some type of positive or negative investment screening process.

Positive screening is usually related to the *operating behaviour* of a business. Investment managers employ

environmental, social and governance (ESG) metrics to guide their investment decisions. Managers may create their own internal ESG measurement system or purchase ESG data/scores from third party providers. That said, these scores are not standardized and are only useful to compare industry peers on a relative basis. These metrics can also be applied to refine passive or index-based strategies. Positive screening may also be referred to as “*best-in-class*” strategies. In summary, positive screening, ESG screening and best-in-class are mostly synonymous terms. The majority of screened strategies fall into the positive category.

It might be expected that negative screening is just reverse of positive screening, but this is only partially true. When negative screening involves the exclusion of companies from a portfolio based on inferior ESG operating scores then it is indeed the other side of positive screening. But negative screening more likely refers to a binary investment policy that excludes companies based on what they sell. Historically products like tobacco, alcohol, weapons, or gambling and pornography services were excluded from screened funds. Increasingly investors are seeking strategies that also exclude fossil fuel producers – “fossil-free” strategies are becoming more common.

As a final point, it is important to note that portfolios that utilize both positive and negative screening strategies tend to have very similar sector and geographic allocations as the benchmarks that they follow. Even strategies like fossil-free that eliminate an entire industrial sector (energy exclusion), generally end up with very similar benchmark weightings in other sectors. **(See Chart 2 below)** This report will not address the performance of specific strategies, but several recent studies conclude that ESG portfolios *generally* end up highly correlated to appropriate benchmarks but on average also outperform them, at least by a small margin.

## [B] Thematic Strategies

Thematic portfolios are built from focused and constrained investment universes. The difference between thematic and screened strategies is most clearly highlighted by their different allocations to industrial sectors. Thematic funds generally tend to be overweight industrial, technology, and utility sectors and are underexposed to financials, health care, energy (fossil) and consumer sectors. That said, thematic funds are usually constructed with significant geographic and company size diversification.

Thematic strategies are constructed by fund managers with a strong conviction that thematic drivers will help specific sectors outperform while at the same time mitigate broader economic risks. As an example, *environmental* theme managers universally support a thesis that companies able to produce more with less will outperform business models that rely on a continuing supply of cheap energy and materials. They also believe that higher commodity costs and regulations to reduce GHG emissions and control other forms of pollution will lead to increased costs for several traditional business sectors.

In recent years the differences between *all* investment products and strategies, including thematic and screened funds, have been somewhat masked by the increasing correlation of all asset classes. By historical standards this has been an unusual development and global asset price performance should eventually uncouple again. When that happens, performance of thematic strategies should diverge from both screened funds and broad indexes. At that time, even a small allocation to a thematic strategy could improve overall portfolio diversification, even more than a screened strategy would.

## [C] ESG Practices

The third second-order label, ESG Practices is not an investment *strategy* per se but rather a group of investment *practices*. In recent years many traditional investment managers have begun to integrate environmental, social and governance issues into investment analyses and decision-making processes. Their integration is based on the belief that early identification of ESG issues could have a material impact on investment performance. The Responsible Investment Association of Canada estimates that almost 80% of managers now pay attention to ESG considerations.

There are three primary ESG practices: First, identifying emerging environmental or social risks that might be overlooked in traditional diligence processes through the integration of ESG factors. Second, to more actively influence the operating behavior of the management teams at companies in which they have invested in through engagement strategies including proxy voting, corporate engagement and shareholder action. Finally, the measurement and monitoring of environmental and social impact is emerging in a variety of asset classes through impact investing.

The Task Force differentiates ESG practices from ESG screening or thematic investing, as these practices are generally not the *primary* driver of an investment thesis. They are not a *strategy* but they are investment *practices*.

ESG practices may be applied to any mainstream investment strategy. For example, a value oriented, emerging markets fund manager could apply ESG practices to their fund in order to identify new risks or promote certain operating behaviours or even to measure the amount of money being invested to address sustainability concerns in certain developing markets. To be even more clear, an environmental theme manager may build her portfolio from specific environmental sectors and pay little attention to ESG operating behaviours. Or they may choose to overlay one or more ESG practices, which several do.

ESG practices are becoming so widespread that it is unusual to find a large investment firm that has not implemented them in one form or another.

## Sector Allocation often separates Screened and Thematic Strategies

In order to highlight the potential differences the Task Force benchmarked the average industry sector allocation of a number of large ESG screened strategies and compared them to a number of environmental theme funds.

**Large ESG Screened Funds vs. MSCI World**  
General Industry Classification

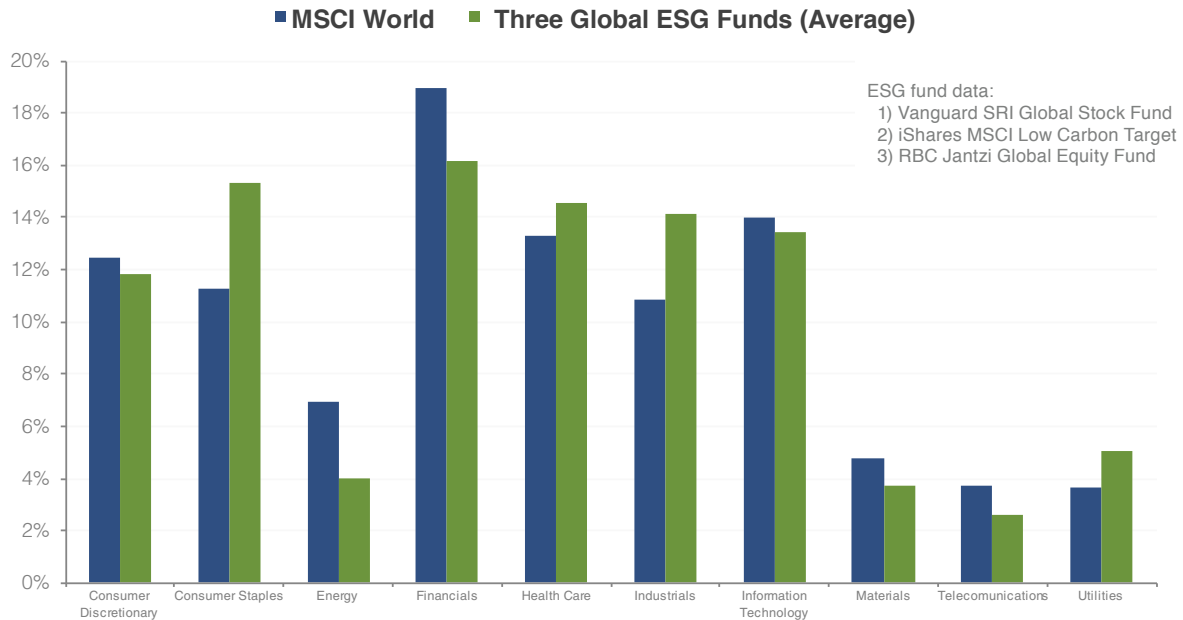


Chart 1

**Six Environmental Theme Funds vs. MSCI World**  
General Industry Classification

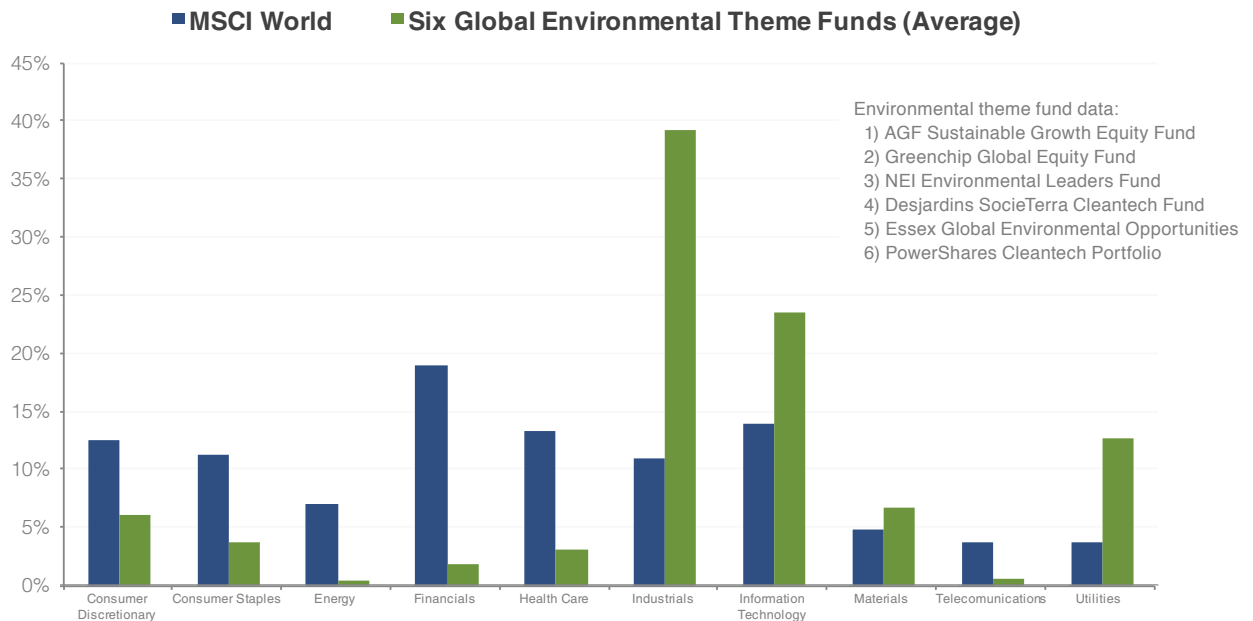


Chart 2

## Labels used to describe sustainable investing at the highest order

In seeking the broadest term that captures all investments within our industry we came across a variety of labels that principally mean the same thing.

**Responsible investing:** Can be used interchangeably with sustainable investing.

**Sustainable investing:** The integration of screening and/or environmental, social, or governance themes into the selection and management of investments. The term often has a time element attached, the idea of creating value for the present generation without compromising the ability of future generations to create value.

**Socially responsible investing:** Historically, socially responsible investing (SRI) was an investment discipline that investors employed to screen out companies based on negative operating attributes such as unfair labor practices or poor environmental practices, or morally suspect products like weapons, tobacco or pornography. More recently, it has become a higher-level label synonymous with sustainable and responsible investing and may apply to both screening and thematic investing.

## Labels related to screening strategies

Screening is a portfolio filtering process used to identify investments with positive or negative operating or product attributes. Screening is one of the most important labels in the sustainable investment taxonomy. The majority of sustainable investment strategies employ some type of screening process. The term also helps to divide all sustainable investment strategies into either screened or thematic.

**ESG:** Environmental, Social and Governance (ESG) is an investment tool used to rank a company's operating behaviour. ESG strategies implement a set of standards and metrics to score and then rank investments based on their environmental, social and governance behaviour. Several services now create ESG scores but there is no standardization of process: they offer relative value only within their own grading system. ESG scores can then be used for both positive and negative screening.

**ESG integration:** The combination of ESG Data, research and analysis together with traditional financial analytics in making investment decisions. Unlike screening, companies are not 'screened in' or 'screened out' of an investable universe. Integration must be verifiable by a transparent and systematic process informed by ESG research and analysis.

**Fossil free:** Exclusion of all companies involved in the ownership, extraction, production, refining, processing, distribution, and/or direct sales of fossil fuels.



**Negative screening:** The exclusion, from a fund or portfolio, of sectors, companies, products or countries based on certain environmental, social or governance characteristics. The most common negative screens exclude fossil fuels, tobacco, gambling, alcohol, and weapons manufacturing.

**Positive screening (best-in-class):** An investment discipline that selects companies based on positive ESG scores/operating performance relative to industry peers.

## Labels related to Thematic Investment Strategies

Thematic investing, as the term suggests, is used to focus portfolios on certain themes. These may relate to companies whose products or services address certain environmental or social challenges. Other themes may focus on poorly governed or managed companies. The motivation for a thematic focus can be investment and/or impact related return.

Because these themes often relate to the environment, social challenges, or governance opportunities, thematic investing can be confused with ESG investing which is a screening practice. The Task force believes thematic investing is a very important term that should be used to differentiate thematic strategies from screened strategies.

**Community housing bonds:** A debt security issued to support community housing initiatives.

**Cleantech:** A term used to describe an investment theme focused on businesses whose products and services seek to increase performance, productivity and efficiency by minimizing negative effects on the environment. Clean technology, generally refers to technologies that address the aforementioned.

**Climate bonds:** A debt security that is issued to raise capital specifically to finance climate-related projects. The issuer of these securities pays for third party verification or labeling, so they can also be called labeled climate or green bonds.

**Efficiency:** A level of performance that describes the amount of inputs in relation to an output. Businesses seek to become more efficient by attempting to minimize their inputs while maximizing their outputs.

**Environmental sectors:** Are generally sectors of the economy pertaining to renewable energy, resource efficiency, transportation, water, food and pollution control.

**Environmental support services:** Companies that provide environmental support services through consultancy, or trading services in environmental assets and securities. Furthermore diversified environmental companies are also included in this sector.

**Environmental theme bonds:** Similar to a Climate or Green Bond except that it is not labeled by a third party. Also environmental theme bonds are not generally issued to finance climate-related projects, but rather to meet the capital needs of companies whose products address environmental issues. Renewable & alternative energy: Companies that provide products and services along the renewable and alternative energy value chain.

**Food, agriculture & forestry:** Companies that improve yield and productivity in agriculture, silviculture, aquaculture, and food production or distribution, whilst minimizing negative environmental impacts. Also, companies who produce, distribute, and/or retail food products with improved health and/or sustainability (e.g. organic) attributes.

**Green bonds:** A debt security that is issued to raise capital specifically to finance climate-related or environmental projects (synonymous with climate bonds).

**Green investing:** Green has become a very general term that loosely implies environmentally conscious business practices, products or services.

**Pollution control:** Companies that provide technologies to reduce and/or monitor the contamination of air, water and soil to address global, regional, and local environmental problems.

**Renewable resources:** A renewable resource is a substance of economic value that can be replaced or replenished in a reasonable amount of time.

**Social impact bonds:** A risk-free way for governments to pursue creative social programs that may take years to yield results. Usually, governments decide what problems they want to address and then enter a contractual agreement with an intermediary (or bond-issuing organization) that is responsible for raising capital from independent investors including banks, foundations, and individuals, and for hiring and managing non-profit service providers.

**Waste management & technologies:** Companies that provide and/or operate technologies, systems and services for waste management, reuse, and recycling.

**Water infrastructure & technologies:** Companies that provide or operate technologies, infrastructure, and services for the supply, management, and treatment of water for industrial, residential, utility and agricultural users.

## Labels related to ESG Practices

**Activist investing:** A strategy used to improve financial returns or change management behaviour through shareholder advocacy, coalition building, and innovative legal strategies.

**Engagement:** Engagement refers to the interaction taken by shareholders to influence company strategy, practices, and disclosures. Engagement usually pertains to ESG issues.

**ESG integration:** The integration of ESG factors into fundamental equity analysis often leading to adjustments of earnings forecasts, growth estimates and discount rates.

**Impact investing:** Impact investing refers to investments with the intention of generating a measurable beneficial social or environmental impact alongside a financial return.

**Proxy voting:** The primary means by which shareholders can influence a company's operations, its corporate governance and even activities of social responsibility that may fall outside of financial considerations.

## Conclusion

The primary conclusion of this study is that beyond the general label of sustainable investing, most strategies fall under either “screening” or “thematic” approaches, and therefore tend to have portfolio profiles associated with those approaches.

As the sustainable investment industry continues to mature we hope that our proposed model will be adopted widely by industry participants. We believe that a strongly defined taxonomy will help increase transparency, decrease confusion and lead to a more efficient allocation of capital within the sustainable investing industry.

We conclude our report with a sincere thanks to those individuals who offered to share their knowledge and time with special thanks to Vimal Selvaraju (Rotman MBA student), the Rotman School of Business, and the Ivey Foundation for their support.

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