# Fight, not flight:

## Shaping a better future through ESG engagement

The fundamental principles of investing continue to evolve globally. Sustainable investing is an opportunity to reshape the future. For consumers, it's no longer enough for companies to create great products or have great performance. There's a growing focus on how these companies behave –how they treat their employees, their suppliers and the environment. This requires a shift in how we analyze and value the companies we invest in. We also need to be more mindful of the investment managers and funds we select.

Plan sponsors understand that offering sustainable investments through their workplace plans can afford important benefits. They can manage risk, enhance returns and engage talent. A recent study of Canadians saving through Defined Contribution (DC) plans found that 79% were interested in sustainable investing. In addition, 72% said they were likely to contribute more if their plan offered these investments.[1] The COVID-19 pandemic has also left its mark. Another study found that 73% of clients believe that businesses have a greater responsibility to support sustainability due to the pandemic.[2]

[1]*Top things you should be thinking about in DC. MFS, July 2020.*
[2]*Financial Health and COVID-19 Omni Study. Sun Life, August 2020.*

Sun Life

## Approaches to sustainable investing - Fight vs. Flight

Sun Life's approach to sustainable investing aligns with our investment philosophy. This is true both for our own assets, and for how we manage and monitor our platform of funds in Group Retirement Services. We believe ***engagement is more powerful than divestment***. We manage our capital with sustainability embedded in our investment processes. We invest our assets to encourage a low-carbon and more inclusive economy. This also aligns with the approach taken by the majority of defined contribution plan sponsors.

We incorporate Environmental, Social, Governance (ESG) factors to manage risks and identify opportunities. ESG integration is the most common Value-based approach. Engagement – the "***fight***" to influence corporate practices – is part of this approach.

In contrast, Values-based investing means applying rules when investing. It can include restricting decision-making or limiting the investible universe based on a set of values. It could also mean using an investment process that gives these factors extra weight. Divestment – or "***flight***" from investments that do not align with desired practices – falls into this category.

## The challenges with divestment – investors lose their voice

A traditional approach to sustainable investing is to divest from companies that harm the environment or produce harmful goods. However, investors who divest lose their voice, voting rights and opportunity to influence ESG issues. While divesting is one approach, it's not the only answer. Investors must engage with companies that consider ESG factors and seek long-term, positive change.

Divestment can be worthwhile if a company fails to meet the investment criteria aligned to its investment strategy. The investment manager may choose to divest ***after*** engagement, if an outcome is still not aligned with investment objectives.

## The opportunity in engagement

Direct, proactive and purposeful engagement on ESG issues can influence positive change. Investment managers can influence how companies tackle ESG issues within their industries. They also have the ability to influence through proxy votes. By engaging, the focus is on improving companies' financial sustainability, reducing business and investment risks, and enhancing returns. This helps companies become more responsible corporate citizens.

Investment managers with a long-term investment horizon are poised to benefit from engagement and ESG integration. Engaging with companies on both financial and non-financial issues can help investment managers make better investment decisions. Doing so can offer insight into how they treat stakeholders, and factors that may impact future cash flows. Engagement has also positively influenced governance and business practices, by demonstrating that these issues are important to their investors.

Active managers may allow for a more focused approach to engage with companies. They have the advantage of being able to divest if engagement doesn't work. This may give them a greater opportunity to gain the attention of company management. Passive managers may be less inclined to engage with organizations that are part of an index. But their sheer size means they have considerable influence through voting power. Three of the largest passive managers – BlackRock, Vanguard and State Street – control a majority of shares on the S&P 500.[3] There is also evidence of a growing commitment by passive managers to be more active in their proxy voting. In December 2020, BlackRock announced a new stance, particularly in support of diversity and climate action on the ballot. Vanguard's 2021 proxy voting guidelines also signal a new openness to voting "For." This is especially true on climate and diversity issues, where they had previously taken a "case-by-case" approach.

Ørsted is a Danish utility company which transformed into a global leader in renewable energy. It's now among the most valuable in Europe, with a market cap that has quadrupled in just four years. It was named the world's most sustainable energy company three years running. Divestment based on sector – in this case coal-based energy – means an investor would have missed out on the successful transition and strong performance. An ongoing dialogue with company leadership enabled investors to help them transition towards a more sustainable business model.

Another notable example of the effectiveness of engagement is athletic wear company Adidas. In this case, MFS untertook a rigorous engagement process to truly understand the extent of sustainable practices. As an early adopter of many sustainable practices, Adidas developed a formal Social and Environmental Affairs team in the late 1990s. They also helped found the Fair Labor Association in 1999. And they created the first shoe made out of ocean plastic in 2015. In 2019, Adidas produced its first fully recyclable performance shoe. The company's long-term sustainability vision includes ending plastic waste and achieving climate neutrality by 2050. It is already using only sustainably-sourced cotton and aims to replace all virgin polyester with recycled polyester by 2024.

[3]Fichtner, J., Heemskerk, Eelke M. and Garcia-Bernardo, J., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk.* Business and Politics, April 2017.

[4]*Hints of Sea Change in Big Fund Company ESG Proxy Votes.* Morningstar, May 2021.

[5]*MFS Case Study. ESG in Action: Adidas – Digging deeper to separate the walk from the talk.* MFS, February 2021.

## The future of sustainable investing – a powerful engagement tool

There is growing recognition among plan sponsors that ESG factors are key drivers of value. It's clear that integrating them can enhance corporate profits and investment returns. There is also evidence that offering sustainable investment options can improve member engagement, plan participation and overall retirement outcomes. Members are able to better understand how the funds in their plan integrate ESG factors. In a recent Sun Life survey, 23% of Canadians who purchased investments said they considered ESG factors. Of the respondents, millennials were most likely to consider ESG factors (34%)[6].

## Our new ESG evaluation framework makes it easy for plan sponsors and plan members to understand sustainable investing

Integrating sustainable investments into workplace plans doesn't have to be complicated for plan sponsors or plan members. Sun Life is proud to offer our Clients and employees a robust, proprietary ESG evaluation framework. This framework is an extension of our ongoing Group Retirement Services investment governance activities. It identifies managers and funds who we believe are ESG Leaders. It also recognizes those who are evolving quickly, and enables plan sponsors and plan members to evaluate the managers and funds within their workplace plans and personal accounts on this basis.

In addition to the framework, Sun Life can offer the following support to **plan sponsors**:

- Understanding the various approaches to sustainable investing.
- Adopting a formal policy on your desired approach and helping document your selection of investment options for plan members.
- Supporting the evaluation of your investment managers' efforts in ESG integration or dedicated sustainable investment products.

For **plan members**, we'll integrate elements of the new ESG evaluation framework into each step of their journey. This allow for ease of understanding, integration of ESG factors within the investment options in their funds.

Although sustainability has long been at the core of Sun Life's business, there's much more to do. We seek to increase our positive effect on society while creating business value, with the ultimate goal of building lifetime financial security for Canadians.

[6] *Financial Health and COVID-19 Omni Study. Sun Life, August 2020.*