Sustainable Investing – Understanding Controversies

written by:

SUSTAINALYTICS

brought to you by:

SCOTIA iTRADE®

Make it happen™.

www.scotiabank.com/itrade/sustainableinvesting

Table of contents

What is sustainable investing?

Sustainable investing is an investment approach that considers how a company manages environmental, social and corporate governance (ESG) factors to generate long-term financial returns and positive societal outcomes. Sustainable investing also encompasses a more values-based approach, commonly referred to as socially responsible investing, used by investors looking to align their investments with their personal values and beliefs.

Sustainalytics is a leading independent provider of ESG research, ratings and analytics to institutional investors. The Sustainalytics ESG ratings measure how well companies have proactively managed ESG factors that can impact their business and stakeholders (which can include shareholders, employees, suppliers, communities, and the environment). Based on a structured and objective methodology, Sustainalytics' ESG ratings provide an assessment on companies' ability to mitigate ESG risks. An important component of the ESG ratings is ESG performance, which is an assessment of a company's involvement in controversial incidents which may negatively impact business or stakeholders.

In this whitepaper, we will discuss why controversies are an important component of a comprehensive sustainable investing strategy.

Embedding sustainability into corporate and investment decisions is integral to long-term success from both a financial and sustainability perspective. Sustainability (or ESG) research and ratings enable investors to make more informed decisions by providing relevant insights about sustainability risks and opportunities.

Unmanaged sustainability issues can have severe consequences, but the extent to which negative business impacts influence investment decisions may be based on an investor's time horizon. Sustainability is not the only driver of financial performance, and our sustainability assessments are typically used by clients to complement financial considerations to form a more holistic opinion of a company.

What is a controversy?

A controversy is a company's involvement in ESG-related incidents. These incidents could include anything from an oil spill or use of child labour, to human rights violations or fraud. Information about controversies, and how a company responds to them, can help investors evaluate that company's performance against its ESG commitments. They can help you to determine whether a company is standing by its stated ESG commitments – if its ESG claims are consistent with its behaviour – or if it is simply using ESG commitments to increase publicity.

Why are controversy assessments important, and what can they tell you?

Frequent involvement in controversies is a sign of exposure to ESG risks and/or the company's failure to manage those risks. A high-profile controversy impacts a company's reputation and often generates a negative market reaction, which could lead to regulatory action, lawsuits, consumer boycotts, community protests or other actions. These consequences, in turn, can impose costs on a company and in some cases, can threaten its ability to continue operating certain projects or in certain jurisdictions. As shown in example #1 (see page 6), a controversy that is unmanaged can potentially lead to an erosion of shareholder value. Investors should pay close attention to a company's involvement in controversies and its response to the controversy, particularly if the involvement is frequent and recurring.

Sustainalytics' controversy assessment ratings feed into a company's overall ESG score. The impact on the ESG score depends on the weight assigned to the controversy. A company's score can move anywhere between 6% to 15%, based on the controversy. (See Glossary of Terms for ESG score / rating)

Investors can use controversy ratings to assess a company's exposure to various risks. Frequent or major controversies may indicate pervasive problems at the company. You might decide to screen out companies with the most severe involvement in controversial incidents, or to lower the weightings of those companies in your investment portfolio.

How the controversy assessment works

Sustainalytics assesses controversies using various criteria to determine the severity of the controversy's impact on stakeholders, the risks it poses on the company's business and reputation, the frequency of incidents, and the quality of management's response. Three main factors are examined:

- **Impact** of a controversy on the company's shareholders, employees and customers, and on the environment and society in general. Impact includes the scope, scale, and duration of a company's involvement.
- **Risks** of a legal, regulatory, operational, financial or reputational nature that may arise as a result of a company's involvement in a controversy.
- **Management** refers to the quality of the company's existing policies and programs that relate to the controversy. It also refers to the quality of the company's response.

Controversies are rated on a scale of "no involvement", "significant", "high" and "severe".

Rating	Critical Rating Elements
NO Involvement in major controversies	Impact on stakeholders and/or the company is low or moderate and the incident poses minimal risk to the company.
Significant	Impact on the environment and society is significant, posing moderate risks to the company (e.g., ongoing litigation or investigations). The company's management response may be inadequate.
High	Impact on the environment and society is high, posing significant risks to the company. Cases are recurring and have not been addressed. Management response is unsound or its implementation of controls or remedies is poor. This rating may reflect structural problems at the company.
Severe	Impact on the environment and society is widespread, severe and irreversible, posing serious ongoing risks to the company. The company is unable or unwilling to correct the issue, or has tried to conceal its wrongdoing or involvement. This rating represents the most egregious corporate behaviour.

To understand how controversy assessment ratings are applied, let's take a closer look at a few examples.

Example #1 – Severe

Type of controversy: Business ethics-related controversy

An international pharmaceutical company was cited by the US Congress for excessively priced drugs, and allegations of accounting irregularities. The impact of excessive pricing on patients was significant in the form of increased insurance premiums or reduced coverage of health plans. Some of the company's drugs were dropped from insurance coverage, depriving patients of much-needed treatment. Shareholders were affected as the company's stock price dropped. The company also faced numerous U.S. regulatory investigations, which could lead to enforcement actions and fines, and a loss of market share to less expensive generic drugs.

Company response: In our view, the company's response has been inadequate. It was criticized for poor transparency to regulators, including allegations of a serious omission of important information.

Controversy Assessment Rating: Severe

Rationale: This severe rating was driven by serious impacts on patients and the company's shareholders, the acute financial, legal, operational and business risks to the company, and the poor management of its different controversies.

Example #2 – Severe

Type of controversy: Business ethics-related controversy

An international construction company was rated severe a few years ago after the company announced an internal investigation into questionable payments and bribery allegations at some of its operations. At the time of the rating, the company also faced severe financial and legal risks. For example, the company received a 10-year World Bank debarment starting in 2013, which impacted the company's ability to attract new projects financed by development banks. The company faced numerous ongoing legal investigations into its operations where a conviction would include a ban on public contracts in Canada.

Company response: Despite operations in other high-risk regions, the company's ethical policies and compliance systems were weak. There was no evidence of a credible anti-bribery program. Since then, the company has improved its management of ethical risks, but at the time of the severe assessment, the company's response was inadequate.

Controversy Assessment Rating: Severe

Rationale: The company's rating was driven by severe risks, and weak management of its response to ethical risks. The rating remains at severe pending the outcome of various bribery investigations.

Example #3 – Significant

Type of controversy: Employee incidents-related controversy

An international telecommunications company has faced serious labour issues, manifesting in multiple employee suicides. The company was given a controversy rating of high for its exceptional labour issues despite having relatively proactive labour management measures.

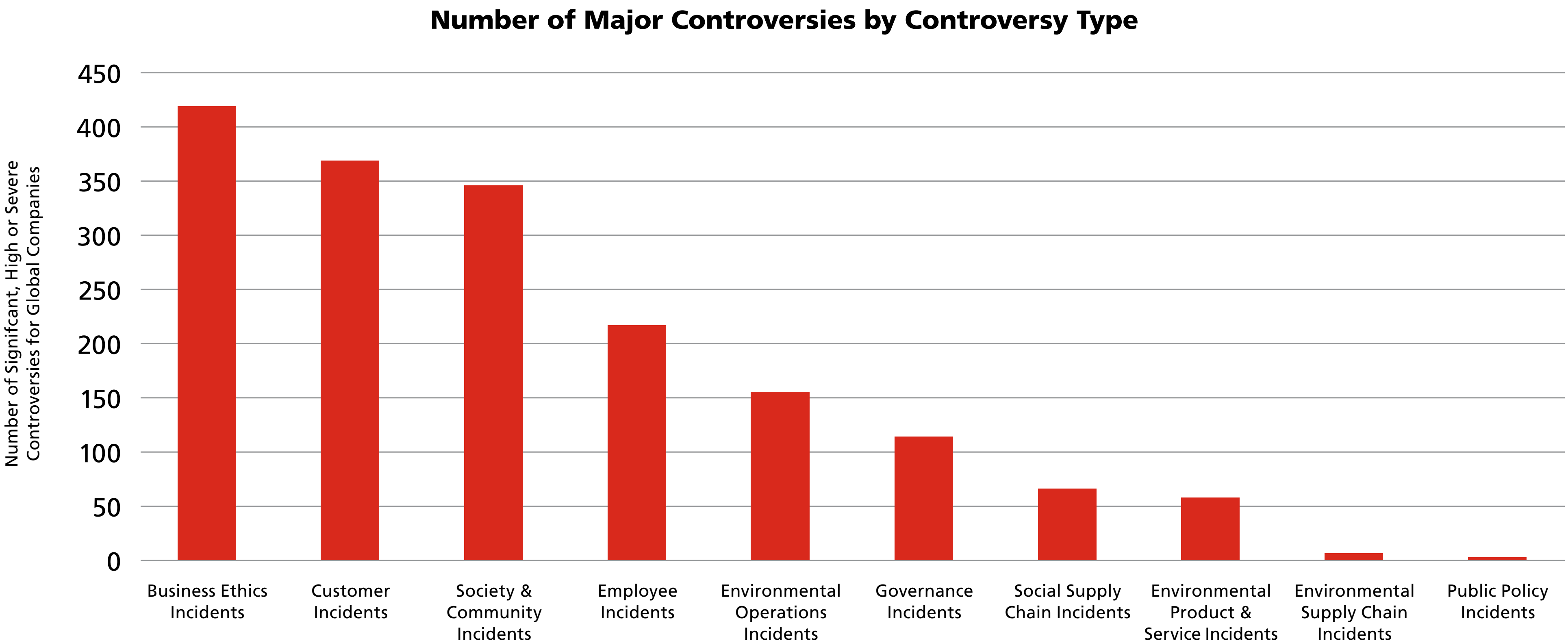
Company response: Over the years, the company has overhauled its employee policies and instituted a change in its management, leading to gradual improvements in labour relations. The number of employee suicides dropped and associated risks to the company have declined over time.

Controversy Assessment Rating: Significant

Rationale: In 2017, Sustainalytics upgraded this company's controversy rating from high to significant to reflect the improvements in labour relations and the company's improved capability to manage future labour risks.

The existence of a controversy isn't the whole story

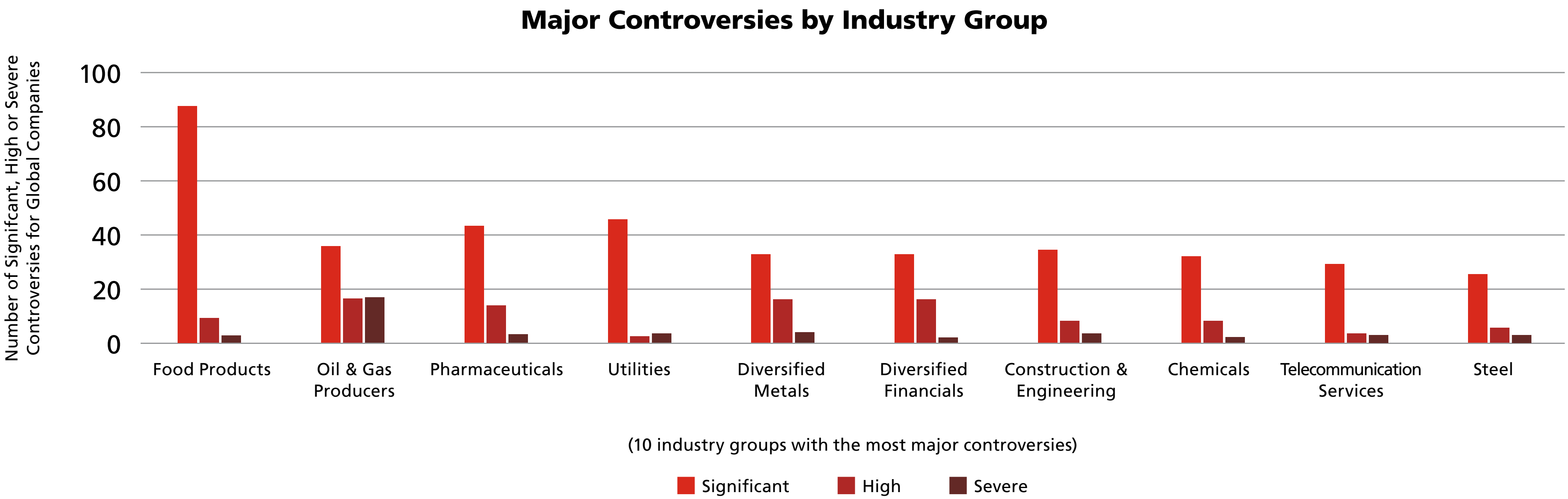
It's important to keep in mind that all controversies are not created equal. The chart below indicates the different types of controversies that exist. Business ethics and customer incidents are among the most common controversies.



Incidents related to business ethics may include accounting irregularities or tax evasion, fraud or bribery, misconduct related to animal welfare, or any sort of breach of intellectual property, such as patents, copyright or trade secrets. Customer incidents, the second-most common controversy type, includes false advertising or misrepresentation, quality and safety issues, or incidents relating to consumers' data privacy.

Source: Sustainalytics' Global Access Research Portal

Companies can also be more or less susceptible to different types of controversies depending on their industry group, as the chart shows below. Some industry groups have a higher exposure to ESG issues than others simply due to the nature of their business. And some industries tend to have controversies that pose lower risks overall than others.



Food products companies, for example, are more exposed than other companies to supply chain risks, spanning issues such as labour, environmental impact of suppliers, and human rights. Controversies can arise for a company if their suppliers are themselves involved in ESG controversies. Managing supply chain risk is difficult because food manufacturers don't have full control over suppliers and influencing the behaviour of these suppliers can take time. Therefore, as the chart above indicates, the food services industry as a whole, tends to be embroiled in more controversies than other industries.

Another industry registering a high number of controversies is oil and gas. Oil and gas producers are in an inherently high-impact, high-risk business, leading to numerous controversies in the industry. Mitigating potential risks is difficult because the products themselves are environmentally harmful and have significant social impacts. In contrast, industry groups such as building products and homebuilders have a lower number of controversies partly because the industry has developed sustainable products that help mitigate environmental impacts.

Source: Sustainalytics' Global Access Research Portal

How controversies can impact a company's value

ESG issues can acutely impact a company's financial performance. A U.S.-based retailer, for example, suffered a data breach involving the financial and personal information of millions of customers. The event received high-profile and intense international media coverage. In the fourth quarter of 2013, following the data breach, the company encountered a 46% drop in sales. That indicates reputational harm, and it cost the company significant promotional activity to retain and attract customers.

How controversies can be a force for positive change

It is important to note that, for companies and for investors, ESG issues represent not only risk but also opportunity. A high-profile controversy can have important consequences for a company: increased legal costs to address lawsuits and regulatory investigations; additional investments to improve internal systems; possible customer backlash; or at worst, divestment by investors. But because of the risks associated with recurring controversies – to the company's finances, regulation, operations or reputation – controversies can become a catalyst for improvement.

> " Business value is increasingly driven by intangibles such as resource efficiency, reputation, social responsibility, business model resilience and capacity for innovation."
>
> *Deloitte*

A company's response to the controversy, therefore, is of vital importance. If there are persistent and recurring issues, the root causes that gave rise to the controversy should be addressed. And the company's commitment should be sustained over time, demonstrating actions associated with its commitments.

The positive impacts of sound ESG management, including avoidance or effective management of controversies, can lead to:

- A stronger brand and greater pricing power
- Supply chain optimization
- Enhanced ability to attract, retain and motivate employees
- Greater employee productivity
- Improved customer loyalty
- Enhanced ability to enter new markets
- Lower market, balance-sheet and operational risks
- Lower costs of capital
- Greater access to capital, financing and insurance

A great example of this is one of the world's leading sports apparel brands. In response to intense criticism over poor labour conditions among its suppliers in Asia in the 1990s, the company implemented a robust due diligence, monitoring and auditing system for its supply chain that is considered best practice in the industry. Moreover, the company was the first in its industry to publish a complete map of its supply chain, aiming to increase both transparency and traceability within the supply chain. After implementing structural reforms, a decade later, the company has become a model for other consumer goods companies.

Source: The Sustainability Initiative Survey, 2009, Boston Consulting Group and MIT Sloan Management Review.

Effective ESG management is crucial to long-term success

Effective ESG management and avoidance of controversies are crucial to a company's strategy. ESG ratings provide relevant insights about sustainability risks and opportunities that let you, the investor, make more informed decisions.

Today's challenges, including resource scarcity, demographic shifts and climate change, are redefining the public's expectations, regulations and business strategies. Companies whose sustainability efforts are embedded in their decision-making processes, and are in line with long-term sustainability goals, are bound to be rewarded by investors.

Meet your ESG research partner, Sustainalytics.

Sustainalytics is a leading independent ESG and corporate governance research, ratings and analytics firm supporting investors around the world with the development and implementation of responsible investment strategies.

For 25 years, the firm has been at the forefront of developing high-quality, innovative solutions to meet the evolving needs of global investors. Today, Sustainalytics works with hundreds of the world's leading asset managers and pension funds who incorporate ESG and corporate governance information and assessments into their investment processes.

With 13 offices globally, Sustainalytics has more than 350 staff members, including over 170 research professionals with varied multidisciplinary expertise across more than 40 sectors.

Through the IRRI Survey, investors selected Sustainalytics as the best independent responsible investment research firm for three consecutive years, 2012 through 2014, and in 2015 and 2016, Sustainalytics was named among the top three firms for both ESG and corporate governance research.

For more information, visit **www.sustainalytics.com**.

To learn more about sustainable investing, visit **www.scotiabank.com/itrade/sustainableinvesting**, or sign into your Scotia iTRADE account.

Glossary of terms

Controversy	A controversy is an event or an aggregation of events that relate to an ESG topic. Controversies are assessed on stakeholder impact and reputational risk to the company. They are also assessed on business risk, frequency of incidents, and an issuer's management of the ESG issue, including its response to certain incidents. A controversy is rated on a scale of Low, Moderate, Significant, High and Severe. Major Controversies may indicate more pervasive behavioural problems at the company.
Controversy Scale	A company's ESG performance based on qualitative information relating to events and incidents that have resulted in negative ESG impacts: • Severe: The event has a severe impact on the environment and society, posing serious risks to the company. This category represents the most egregious corporate behavior. • High: The event has a high impact on the environment and society, posing significant risks to the company. This category often reflects structural problems in the company. • Significant: The event has a significant impact on the environment and society, posing moderate risks to the company. • Moderate: The event has a moderate impact on the environment and society, posing minimal risks to the company. • Low: The event has a low impact on the environment and society, posing negligible risks to the company
Environmental Performance Assessment	Environmental Performance Assessment measures how well issuers proactively manage environmental issues that are material to their business, relative to global industry peers. The Environmental Performance Assessment is based on the issuer's ability to manage environmental risks through applicable policies, programs and management systems, the effectiveness or performance of such risk management, as well as on an assessment of any involvement in negative impacts on the environment. An issuer's level of transparency and the extent to which its reporting aligns with best practice is also an important factor in the overall Environmental Performance Assessment.
ESG	Environmental, Social and Governance
ESG Rating (Score)	The assessment of a company's (issuer's) overall ESG preparedness and performance, represented by an absolute score of between 0 and 100. ESG Ratings measure how well issuers proactively manage the environmental, social and governance issues that are material to their business. Based on a structured and objective methodology, ESG Ratings provide an assessment on companies' ability to mitigate ESG risks. The following dimensions are assessed for the Environmental, Social and Governance Scores: • Preparedness measures an issuer's ability to manage ESG risks through policies, programs and management systems • Performance is a way to measure the effectiveness of an issuer's preparedness to manage ESG risks. • Disclosure is tracked to measure an issuer's level of transparency and the extent to which its ESG reporting aligns with best practice by tracking an issuers reporting and the use of third-party and verification standards.

Glossary of terms

ESG Performance Assessment	The company's performance classification is relative to its global industry peers, based on the company's absolute ESG score. Each industry, or peer group, has a fixed band of scores that links to a relative position range. Companies can fall in five categories: laggards, under-performers, average performers, outperformers and leaders. The industry-specific bands are based on the ESG scores of approximately 4,200 companies that are assessed under Sustainalytics Comprehensive ESG Ratings framework. The bands are reviewed and updated annually. Relative position based on ESG Rating:

PERFORMANCE CLASSIFICATION	ESG SCORE BAND
Leader	Within the top 5% in the industry
Outperformer	Within the top 5% to 16% of its industry
Average Performer	Within the mid-range, 16% to 84% of its industry
Underperformer	Within the bottom 5% to 16% of its industry
Laggard	Within the bottom 5% of the industry

ESG (Rating) Report	The report reflecting the research on an issuers preparedness and performance, as well as the ESG Rating (Score) of an issuer.
Governance Performance Assessment	Governance Performance Assessment measures how well issuers proactively manage governance issues that are material to their business, relative to global industry peers. The assessment is based on the issuer's ability to manage governance risks through applicable policies, programs and management systems, the effectiveness or performance of such risk management, as well as on any involvement in negative impact related to governance issues. An issuer's level of transparency and the extent to which its reporting aligns with best practice is also an important factor in the overall Governance Performance Assessment.
Industry (Peer) Group	Classification of the ESG Rating Research Universe. This classification is also referred to as "Peer Group" in ESG Rating reports. Issuers are identified using 42 global peer groups based on internationally accepted standards, but has modified this classification for more meaningful comparability within the industry group.
Peer Group Score Range	The range of company scores specific to a given peer group and that fall within the Research Universe (TSX and Russell 1000). This can be thought of as a regional peer group score range.
Relative Rank	The company's performance classification is relative to its global industry peers, based on the company's absolute ESG score. The relative performance allows for comparability in the peer group or across multiple peer groups.
Research Universe	Overall ESG Ratings are based on global peer groups. The research universe provided is the TSX and the Russell 1000.
Social Performance Assessment	Social Performance Assessment measures how well issuers proactively manage social issues that are material to their business, relative to global industry peers. The assessment is based on the issuer's ability to manage social risks through applicable policies, programs and management systems and the effectiveness or performance of such risk management, as well as on an assessment of any involvement in negative impacts on society and stakeholders. An issuer's level of transparency and the extent to which its reporting aligns with best practice is also an important factor in the overall Social Performance Assessment.