Responsible Investing: An Investor's Perspective

Conference Board of Canada - National CSR Conference

Don Raymond
Senior Vice President, Public Market Investments

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Good afternoon, everyone.

It's a great pleasure to be here today for the Conference Board's national CSR conference.

At the CPP Investment Board we have had the privilege of working closely with the Conference Board through our sponsorship of the Carbon Disclosure Project's Canada Report, which helps put into perspective the potential opportunities and risks related to climate change for Canadian companies.

I'll have more to say in a moment about the importance of this kind of information. For now, I would simply like to commend the Conference Board for all the work it does, and to thank you for inviting me here to speak today.

February 25th, 2007 was an important day in the evolution of corporate sustainability. Now some of you will no doubt assume I'm referring to "An Inconvenient Truth" receiving the Oscar for Best Documentary. Surely, that was an important moment in raising global awareness of the climate crisis.

But I'm thinking of something else that happened that day that probably involved a lot more strong coffee and cold pizzas than black ties and champagne…and **that** was the signing of a deal by KKR, Texas Pacific Group and the private equity arm of Goldman Sachs to acquire TXU Corp., a Texas utility, for US$45 billion, including the assumption of TXU debt.

Amazingly, given the size and scale of private equity transactions being done today, there is actually nothing terribly remarkable about that, in and of itself.

What *was* remarkable is that in making its bid, the buyers – and we're talking about three of the savviest, most successful and most return-driven investment firms in the world -- pledged that under their ownership, TXU would:

- Cancel proposals to build eight of eleven coal-fired power plants the company had planned to build in Texas;

- Back legislation that would require reductions in carbon dioxide and set up a cap-and-trade system for managing CO_2 emissions;

- Spend $400 million to buy or create more renewable power;

- Tie executive compensation to environmental metrics;

- Consult with a new environmental advisory board that would include representatives of the Environmental Defense Fund and the Natural Resources Defense Council; and

- More seriously explore the use of cleaner-burning coal technologies than it had ever done before.

We can draw at least two conclusions from all this.

One is that KKR, TPG and Goldman took a pragmatic view that these pledges were the cost of doing business – in other words, that they were the price of obtaining the regulatory approvals needed to acquire TXU. Another is that they see financial upside – *significant* financial upside – in putting sustainability at the core of their strategy.

In fact, it seems clear that the two points are inseparable. Without the pledges, there would have been no investment opportunity. And without the ability to adopt a more sustainable strategy – *and* generate significant long-term cash flow – there would have been no pledges.

I'll come back to this in a few minutes. But for now, it's enough to say that if this transaction is any guide, the argument presented by the title of this year's conference – "Connecting Business Value with CSR" -- may already have been won…at least in some quarters…!

I certainly wouldn't be here if we at the CPP Investment Board didn't believe the connection was real and meaningful. In a moment, I'll discuss the CPP Investment Board's Policy on Responsible Investing – what it is, why we have it, and what it may mean for Canadian companies. I'll also talk about how we are engaging companies on environmental, social and governance issues, and where we will be focusing our attention in the year ahead.

But first it's probably helpful to spend a few minutes talking about the CPP Investment Board itself.

The CPP Investment Board is an investment management organization that manages the assets of the CPP reserve fund to help sustain the future pensions of the 16 million Canadians who participate in the CPP

In 2000, the CPP fund had assets of 44.5 billion dollars. At December 31, 2006, the fund had more than doubled to just shy of 111 billion dollars.

Based on current contribution rates and expected investment returns, Canada's Chief Actuary projects the CPP fund will grow to approximately $250 billion by 2016. This makes the CPP fund one of the largest and fastest-growing single-purpose pools of investment capital anywhere in the world. Importantly, the Chief Actuary has also stated that the Canada Pension Plan is solvent and sustainable throughout the 75 years of his forecast period.

The stability of our national pension plan puts Canada in a very strong position relative to other countries around the world. The strength of Canada's position can be attributed to the thoughtful and far-sighted nature of the CPP reforms implemented in 1996/97 by the federal and provincial finance ministers, including Alberta, who act as stewards of the Plan.

These reforms have become internationally recognized as a best practice model for national plans. I'll briefly highlight a few key elements:

- The CPP assets are held in a segregated fund and can only be withdrawn to pay benefits or administer the plan.

- Contributions to the fund are solely from employees and employers and are not co-mingled with any government revenues.

- The fund is managed at arm's length from governments by the CPP Investment Board with a strong, private sector-based governance model.

- And we have been given a very clear, indeed explicit, investment-only mandate to maximize investment returns without undue risk of loss.

Policy on Responsible Investing

It is through the lens of this "investment only" mandate that we analyze responsible investing in order to frame related issues within a risk/return investment context.

Our approach to responsible investing is detailed in our Policy on Responsible Investing. Designed entirely within an investment framework, responsibility for its implementation rests with me in my capacity as the head of our public market investments group. As of December 31, 2006, this part of the portfolio totaled approximately 98 billion dollars, which I suppose is a way of saying that we take responsible investing seriously.

At its core, the policy reflects our belief that responsible corporate behaviour with respect to environmental, social and governance factors – commonly referred to as ESG factors – can generally have a positive influence on long-term corporate financial performance.

Consequently, we approach ESG issues not with a social agenda, or an environmental agenda, or even a governance agenda per se, but rather, with a fiduciary investment agenda that analyzes and seeks to incorporate ESG factors to the extent that they affect risk and return.

We generally believe that the business risks associated with ESG factors tend to play out over long periods of time, and so we assess ESG-related risks and opportunities against our long-term investment horizon.

At the same time, we are mindful that, like climate change itself, investment risks can build gradually over decades but the consequences can come suddenly through shifts in consumer sentiment, the emergence of disruptive technologies and perhaps most of all, regulatory change…which is one reason we have a certain sense of urgency these days about how we approach ESG issues within the portfolio.

For the CPP Investment Board, our goal is to encourage disclosure practices and corporate conduct with respect to ESG matters that enhance long-term financial performance.

The policy has three core elements:

First, is engagement with companies in our portfolio through proxy voting, coalition building and direct communications with managements and boards;

next, we help to fund and conduct research into the long-term materiality of ESG factors; and

third, integrating ESG factors into our investment processes.

First, let's talk about engagement, which is a proven strategy to encourage improved performance on and disclosure of ESG issues. We believe that when investors speak out, corporations take note and can be encouraged to take action.

The CPP Investment Board speaks with various investor groups, NGOs and industry associations on a regular basis to explore collaborative engagement opportunities. A good example is our support of the Carbon Disclosure Project. A coalition of 284 investors globally managing more than US$41 trillion in assets, the CDP is designed to encourage companies around the world to disclose the implications of climate change to their business.

We also work with like-minded investors to advance fiduciary -- or investment-oriented -- frameworks for responsible investment.

In April 2006, our CEO David Denison and I joined Kofi Annan in New York for the launch of the United Nations' Principles for Responsible Investing. Now backed by 120 leading investor signatories with more than US$6 trillion under management, these are a set of investment-oriented principles for responsible investing. As the CPP Investment Board's point man, I had the privilege of being the sole Canadian investor involved in the development of these principles.

We are also building our engagement capabilities to engage with companies directly.

- We prioritize issues and identify firms for direct engagement based primarily on their potential impact on our portfolio, as well as research from various sources, including independent research providers.

- Our direct engagement on ESG issues has been mostly with Canadian firms, where on average we own 2 to 3 percent of shares outstanding.

- Once we have identified a firm, we review the firm's financial and ESG performance and develop objectives for our engagement. We seek dialogue with senior executives, board members, investor relations and/or the sustainability manager at the firm. We generally seek improved transparency on relevant ESG factors and assurance that the company is adequately managing relevant ESG issues in the short and longer term.

- While we reserve the option if companies are unresponsive, we generally do not publicly disclose the names of the companies with whom we are engaging. In many cases engagement is an ongoing, long-term process with companies.

- To date we have directly communicated with companies in a number of industries including mining, tobacco, IT and energy to encourage the improvement of disclosure and performance on ESG factors.

- Proxy voting is another effective form of direct engagement.

- Our Proxy Voting Guidelines state that: "The CPP Investment Board will support resolutions that request the reasonable disclosure of information related to ESG factors."

- They also state that we will support the adoption of responsible policies and practices that are likely to enhance long-term corporate financial performance. One example of a standard for business conduct we support, where applicable, is the OECD Guidelines for Multinational Enterprises.

- In 2006, we voted on 12,400 proxy resolutions at shareholder meetings. We are transparent on our proxy voting, disclosing how we voted on our website the day following the vote. Canadians can see how the CPP Investment Board voted at www.cppib.ca.

In addition to engagement, we support research into the long-term financial materiality of ESG factors.   In March 2006, we were the first Canadian investment organization to join the Enhanced Analytics Initiative. This is an international collaboration of investors representing over 2 trillion dollars in assets aimed at encouraging better investment research into ESG factors. We are augmenting the work of the EAI and others in the investment research community with work being conducted internally as we seek greater insight into these issues and potential investment risks or opportunities.

Finally, we are working towards building ESG factors directly into our investment strategies. We are working to gain insight into the less apparent elements of corporate performance, risk and opportunity as they relate to ESG factors. This is not to say we are discarding traditional research methodologies. Those remain as central as ever. But we are not willing to ignore things we know are there just because they can't easily be measured.

We are also integrating ESG factors into our investment strategies on a far less conceptual level, with the development of a relationship investment capability inside the public market investments department.

This team is responsible for implementing our policy and managing our direct engagement efforts and will also execute strategies involving direct engagement of companies with a primary objective of adding incremental value to the public markets investment portfolio.

As with most other parts of the total CPP fund, our investment horizon and orientation for the relationship investment strategy are long term. This approach allows a strategic investor like us to give management and boards the shareholder stability required to make the investments in their business that are required to create long-term value. Our focus here won't be limited to ESG factors, though they are clearly within the scope of the kinds of opportunities we may find.

Focus Areas

So far I've spoken quite broadly about the CPP Investment Board and our Policy on Responsible Investing. In the time remaining I'd like to zero in on issues we believe will have significant potential impact on our portfolio.

We recently identified three areas of focus for our engagement activities. These are: the extractive industries – those being oil & gas, and mining; climate change; and executive compensation.

I said earlier that we approach responsible investing from an investment management perspective.

We have opted to focus on engagement with companies in the extractive industries for two reasons. One, because they are so prevalent in the Canadian economy and therefore, within our investment portfolio. And two, because companies in the extractive industries typically deal with a wide range of environmental, social and governance factors that can – if managed well or poorly – translate into more or less favourable prospects for long-term financial performance.

Last month, the Federal Government announced Canada's official support for the Extractive Industries Transparency Initiative. A coalition of governments, industries, investors and NGOs, EITI is based on the belief that transparency and good governance are preconditions for converting government revenue from the oil, gas and mining industries into broad-based economic growth.

Today, I am very pleased to announce for the first time the CPP Investment Board's support for the Extractive Industries Transparency Initiative.

It is the EITI's view that "Political instability caused by opaque governance is a clear threat to investments. In extractive industries, where investments are capital intensive and dependent on long-term stability to generate returns, reducing such instability is beneficial."

We subscribe to that view and believe that companies and countries that adopt the principles of EITI can reduce political and reputational risk, thereby improving their prospects for delivering long-term value to their shareholders.

Many oil & gas and mining companies are already transparent in their financial reporting on tax and royalty payment information in the countries where they operate, so the EITI should not be a significant burden to them.

Our second focus area is climate change. Here, we believe that the effects of climate change and the corresponding regulatory response will have significant economic consequences. It follows that it will have significant implications from an investment perspective in many parts of our portfolio.

Climate change is an emotional issue for a lot of people, so I want to be clear that we are not trying to dictate or even define what companies or governments should or shouldn't do about it. What we want is for the companies we invest in to be as transparent as possible about their carbon impact and their plans for mitigating it so that we and other investors can incorporate these factors into our analysis of risk and return.

That is true for us whether the risks are posed by the potential effects of climate change itself, shifting consumer or investor sentiment, or potential regulatory changes such as the adoption of caps, carbon-based taxes, emissions trading and so on.

We are not focused, by the way, solely on negative impacts. As with any market shift, awareness of climate change and efforts to reduce, tax or regulate carbon emissions will have winners and losers, leaders and laggards. As investors, we need to know who will likely fall into which category so that we allocate capital accordingly.

Our efforts are directed at encouraging companies to disclose the relevant carbon impact of their activities clearly and consistently so that investors can analyze and assess the potential risks and opportunities inherent in their business.

The key, however, is getting the data, which is why the CDP Canada report I mentioned earlier is so important. Getting the data is critical. But getting structured and comparable data must be the real objective. As an accounting standard, GAAP may have its shortcomings, but at least it's structured, defined and consistent from one company to the next. We need a GAAP for measuring a company's carbon footprint.

Comparable, reliable disclosure ensures that common information is disseminated which then allows for more effective analysis. This kind of structured disclosure benefits both investors and companies. It helps clarify for companies what type of information investors are looking for, and in turn, investors can then readily use this information as part of their investment decisions.

A lot of progress has been made in terms of research and analysis on potential implications of climate change for companies, with numerous reports on this issue being written by global investment dealers in recent months. Creating a large public database of comparable data is an important step in that effort, in that it facilitates company specific analysis. This year, we plan to analyze the CDP responses of Canadian companies from an investment perspective in order to provide feedback on which areas of disclosure are most useful or could be improved.

One final point on climate change. I've told you what we, as investors, want to see from companies. What we want from government is equally straightforward, and that is regulatory certainty. As everyone here knows, markets dislike uncertainty, perhaps even more than you all do. Regulatory certainty will provide the framework for market forces to drive positive change on ESG factors.

Our third focus area is executive compensation. I won't spend a lot of time on this today. Like most investors, we believe in paying for performance, with two qualifications. The first is that pay be correlated with both good *and* bad performance. The second is that companies provide full disclosure of the *true economic value* of executive packages. It seems so easy when you say it…but it isn't always the case. The Canadian Coalition for Good Governance has made significant progress in this regard with Canadian companies. We will be devoting more attention to this issue going forward.

Conclusion

In all their various forms – be it the CDP, EAI, EITI, or the UNPRI – literally trillions of dollars of investment capital are lining up behind the belief that ESG factors matter.

Corporations around the world are demonstrating that sustainability is not only possible, but beneficial from an investment perspective. The global climate is in flux, and the potential consequences are massive. There are risks and opportunities of a kind and magnitude we seldom see. Consumer sentiment is lining up behind sustainability in a very powerful way. And regulatory change is coming. The political imperative makes that a certainty. What form it takes in jurisdictions around the world and how companies respond will define the leaders and laggards of the 21st century.

I'd like to leave you with a few final thoughts.

One. The disclosure requirements for initiatives like EITI and CDP should not be considered onerous or unique. In fact, they should be considered best practices for all management teams and boards as they look to create long term value and manage risk for their shareholders in an increasingly complex world.

Two. As investors we will support and celebrate the corporate leaders in creating a culture of transparency as it relates to ESG issues. And as partners of management we will role up our sleeves to work with the laggards since we will all benefit -- as investors and as participants in the CPP -- at the end of the day.

And three: Often when people talk about sustainability and responsible investing, they talk about our obligation to future generations. As investors with a mandate to help sustain the Canada Pension Plan for the benefit of more than 16 million Canadians, we talk about that obligation every day. We have a long-term investment horizon and a very deep commitment to managing long-term portfolio risks.

I hope my remarks today have helped explain our mission, our mandate, our policy on responsible investing and how we are engaging the companies in our portfolio to drive better disclosure of, and corporate conduct on, environmental, social and governance factors.

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I'll now be happy to take your questions.