UNIVERSITY OF TORONTO

OFFICE OF THE VICE-PRESIDENT, BUSINESS AFFAIRS

Responsible Investing Committee

Annual Report
April 2009 – June 2010

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WHAT IS RESPONSIBLE INVESTMENT?

Responsible investment is a fast-growing innovation that offers investors an approach to synergize long-term returns with positive growth in business norms on environmental, social, and corporate governance (ESG) standards. Investors are not seen as mere passive providers of capital but rational agents that can tap into unused "shareholder power" potential that stems from corporate executives' legal duties as trustees charged to maximize shareholders' interests, not merely maximize short-run profits. Shareholder power is most visible in shareholders' right to vote on and propose resolutions at meetings of the company. However, larger institutional shareholders have more formal and informal powers to influence managers' behavior. These range from informal conversations with management to the participation in larger shareholder coalitions and can be aimed at individual firms, the larger industry, or governmental agencies.

The premise of responsible investment is that ESG factors often unfold in an environment of asymmetric information, in which investors lack vital information to evaluate the riskiness of an investment and thus its reasonableness. Traditional financial models have accounted for a variety of 'intangibles', such as goodwill. Responsible investment seeks to rectify the gap in information on ESG issues which such models to date have been slow to address. The premise of an efficient market is full, true, and clear disclosure. The uninformed investor is in a situation that can lead to disastrous results. The financial crisis should make us all more attuned to the fragility of the market and the need to view ESG risk in light of corporate scandals, such as Enron, costly litigation battles (e.g. Chevron), and environmental cleanups, such as BP oil. Companies that are "skating on thin financial ice often have small armies of accountants devoted to arranging financial statements designed to lull investors into a false sense of security".[1] ESG factors can be used to discern negative trends because it may be harder to hide from the public, primarily as "few companies have – or even can have – similar powers over their social and environmental reporting, for they are seldom in sole control of such information."[2]

> "Investors who pay attention to ESG issues know that disasters are often not surprises. Nothing plagues markets more than uncertainty and imperfect information, and much of the business of finance is the relentless pursuit of better information. With it, investors can anticipate, and anticipation means fewer surprises, the bête noire of the prudent investor."
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> - UNEP, *Show Me the Money: Linking Environmental, Social and Governance Issues to Company*

A useful illustration of the cost impacts of ESG factors is the upcoming environmental externalities of climate change. New carbon legislation may initially seem to only be a risk to carbon-intensive industries, such as oil/gas and utilities, potentially affecting their cost-structures in a regulated *and* unregulated environment. Yet, this decision will have "ripple effects across all sectors" and firms that "seize an early opportunity by developing technologies in anticipation of this changed environment may offer a lower risk profile and enhanced return opportunities."[3] For a diversified investor, environmental costs from such externalities may be unavoidable returning in the form of "insurance premiums, taxes, inflated input prices, and the physical cost associated with disaster", reduced "future cash flows and dividends", and causing spillover losses into other

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[1] UNEP Finance Initiative, *Show Me the Money: Linking Environmental, Social, and Governance Issues to Company Value* (Geneva, Switzerland: 2006), 8.

[2] Ibid., 8.

[3] Centre for Financial Market Integrity (CFA), *Environmental, Social, and Governmental Factors at Listed Companies: A Manual for Investors* (New York: 2008), 4.

portfolio holdings.[4] With an estimated US$ 6.6 trillion in environmental damages from human activity in 2008 alone, 11% of the global GDP, this is an externality that cannot be ignored.[5]

Three factors may make responsible investment an interesting fit for an institutional investor such as the University of Toronto:

- Diversified large 'universal investors' need to employ cost-effective strategies to protect against negative trends in the growth of the economy at large;
- Long-term investment horizon in its endowment and pension liabilities may expose the fund to additional externalities but also enable it to seize unique long-run opportunities;
- Heavier weight of Canadian and American equities may be an additional regulatory and legal risk should either state respond to ESG externalities due to shifting domestic or global political agendas;

ABOUT THE RESPONSIBLE INVESTING COMMITTEE

Mandate of the Committee

The Responsible Investing Committee (RIC) was created in April 2009 to serve as an independent advisory body to inform and make policy recommendations to the Division of Business Affairs on how environmental, social, and corporate governance (ESG) factors could supplement investment analysis. It is based on consensus that for a company to be financially successful in the long-term, its management must engage in sustainable and sound business practices. The areas that the RIC are charged with investigating include, but are not limited to, environmental issues, labour practices, health and safety standards, the rule of law, and individual and property rights.

The RIC is primarily a forum for interested parties to discuss and develop ideas for ESG integration in the University of Toronto context. However, its secondary purpose is to extend the discourse and debate on ESG integration and responsible investment beyond the RIC itself. It seeks to encourage cooperation and discussion between the various elements of the University, research networks, industry professionals, shareholder groups, and other relevant participants.

Composition of the Committee

The RIC attempts to facilitate a diverse perspective on ESG factors with at least one of the eight positions drawn from all four of the primary University communities: students, faculty, administrative staff, and alumni. Members are encouraged to bring their own expertise and their experiences so as to enrich the RIC forum. In order to facilitate collaboration and the exchange of information, representatives from the Division of Business Affairs and investment managers, namely the University of Toronto Asset Management Corporation, routinely participate in the proceedings.

For a complete list of the eight RIC members in 2009-2010 and their contact information,

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[4] UNEP Finance Initiative, *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors* (Geneva, Switzerland: 2010), 3.

[5] Ibid., 3.

please refer to the *Membership* section of this Report.
Subcommittees of the Committee

While much of the agenda-setting and policy discussion are the exclusive domain of the RIC and its members, subcommittees are from time-to-time created to engage in necessary research and outreach efforts. In 2009-2010, three subcommittees were established (open to all members of the University) to facilitate different areas of the RIC mandate:

The General Policy on ESG Subcommittee was charged with exploring the diverse ESG policy frameworks of institutional investors in order to create a general ESG guideline to direct the actions of investment managers. Particular emphasis was on identifying best practices for laying the groundwork for a proxy voting standard[6] for the University of Toronto.

The Proxy Voting Committee reviewed the University of Toronto's proxy voting record over the past year, analyzed the results, and collaborated with the General Policy on ESG Subcommittee to formulate recommendations on ways in which U of T may more effectively vote its proxies in order to both increase shareholder value and demonstrate commitment to responsible investing.

The Community Outreach and Issues Identification Subcommittee canvassed University of Toronto to better understand the ESG issues that the University community finds most important. This outreach was conducted to direct and develop a shareholder engagement strategy attuned with the intents of the University of Toronto stakeholders.

Further discussion of the output of these subcommittees in the 2009-2010 year can be found in subsequent sections of this Report.

ACTIVITIES OF THE RESPONSIBLE INVESTING COMMITTEE

In its inaugural year, the RIC had to take on the difficult task of deciding the appropriate initial exercise(s) of shareholder engagement for the University. To this end, the RIC focused on the proxy voting dimension of engagement, empowering the subcommittees to contrast UTAM's current activities with academic standards and industry leaders. Additionally, the RIC sought to network with industry and University stakeholders to foster the exchange of information and to promote future cooperation in research and awareness efforts.

Networking and Consultations

The RIC took opportunities in 2009-2010 to meet with professional consultants in order to expand its knowledge of ESG analytics and source ways external agents could potentially serve in a supporting role to the University in adapting ESG factors into investment processes.

On 11 August 2009, RiskMetrics presented to the RIC their capabilities of incorporating ESG issues into proxy voting. In accordance with their business principles, RiskMetrics shared with the RIC some internal processes, methodologies, and analytics that its industry vendors utilize to develop voting policies and recommendations. The RIC was thankful to have such a

[6] Proxy voting refers to resolutions presented at corporate meetings that are voted on by an outside party (e.g. outsourced investment manager) on the behalf of the University.

leader in ESG risk mitigation impart its investment philosophy.

On February 4th, 2010, Trucost presented sustainable investment research and showed how its firm has become renowned for its capacity to quantify environmental risks such as GHG (greenhouse gas) emissions, water abstraction, natural resource depletion, and air pollutants. The RIC is grateful to Trucost for sharing their expertise, which has earned them renown from the UNEP[7] and made them a staple of the Newsweek Green Rankings. Trucost mentioned that academic institutions may be able to access their research information at a reduced cost, an opportunity that the RIC will continue to explore in the future.

The RIC also built relationships with other notable academic networks active in the area of responsible investment, such as Carleton University's Responsible Investing Initiative and the Principles for Responsible Investment (PRI) Academic Network. A representative of the RIC attended the UN PRI 2010 Academic Conference in Copenhagen, in which he presented an original paper to the audience on fiduciary duty.

Deferring Judgment on Pre-Packaged Standards

On 26 January 2010, the RIC decided to defer judgment on adopting packaged policies, such as RiskMetrics' SRI Policy[8], until more research could be conducted on broader statements of proxy voting, such as favoring disclosure motions, and how outside investment managers could be evaluated under alternative regimes. Alternatives that were discussed included the use of a customized vendor package or an in-house policy standard with appropriate monitoring and enforcement mechanisms. Specific social and environmental issues were identified as difficult to achieve a consensus throughout the University, and thus the RIC favored inquires into broader language that could still synergize long-term returns with positive business standards.

Creation of RIC Website

A preliminary website (http://www.utoronto.ca/ric) was uploaded to the University servers to host vital information and updates on the RIC's activities. This includes the mandates of the RIC and its subcommittees, members' contact information, upcoming events, and links to UTAM information and relevant developments in the field of responsible investment. On the approval of this Report, it shall be added to this site so as to facilitate greater public access to the RIC.

ACTIVITIES OF THE GENERAL POLICY ON ESG SUBCOMMITTEE

2010-2011 Roadmap for ESG Policy Research

In 2009-2010, the General Policy on ESG Subcommittee was tasked with finding a set of ESG risk criteria that could lay the groundwork for future evaluations of proxy voting options. In addition to a review of the academic literature, the Subcommittee examined similarities in the policies of several investors on topics ranging from board diversity to the Kyoto Protocol. Case studies included RiskMetrics, Calvert Investments, Progressive Asset Management (PAM),

[7] UNEP, *Universal Ownership*, 3.

[8] An SRI policy refers to a "socially responsible investment" policy that is designed to guide proxy voting or other investment decision-making to reflect ESG risks.

Trillum Asset Management, DWS Investments, Green Century Capital Management, JPMorgran Asset Management, Rockefeller Brothers Fund, and Northwest and Ethical Investments LP.

The Subcommittee's findings were that ESG arguments could be broken down into four main criteria areas. These four criteria areas were each distinct, and each served to illuminate a different opportunity to supplement the University's investment strategy:

- *Legislative or Regulatory Factors*: Risk that laws and regulations affecting the business' operations are subject to change and the possibility of adverse consequences on continued profitability or long-term competitive advantage;

- *Legal Factors:* Risk associated with lawsuits or other kinds of litigation action that may negatively impact profitability via settlements or diverted economic resources;

- *Reputational Factors*: Risk associated with the public perceptions of corporate performance and its impact on the strength of brand loyalty and market share;

- *Operational Factors*: Risk that traditional business operations may be unsustainable or be far less cost effective solutions without adequate ESG strategic adaptation

In its final report, *2010-2011 Roadmap for ESG Policy Research*, the Subcommittee stated the CFA's framework for presenting this criteria and its useful research question suggestions should be adopted by the RIC for future research endeavors.

The *Roadmap for ESG Policy Research* was APPROVED by the RIC on May 27, 2010

ACTIVITIES OF THE PROXY VOTING SUBCOMMITTEE

SRI Audit of UTAM's Top 50 Public Holdings

With assistance from UTAM and RiskMetrics, the Proxy Voting Subcommittee was able to obtain a side-by-side comparison of the 2009 proxy voting decisions of UTAM versus the SRI Policy of RiskMetrics on UTAM's top 50 public equities. This represented data on approximately 1186 total shareholder resolutions, representing all three ESG areas. In 9.1% of resolutions, the UTAM investment managers voted against management's recommendation. The Subcommittee found that to follow the SRI Policy would result in 23 different decisions, and represent a 2.9% increase to 11% total resolutions voted against.

The SRI Policy differed in 23 cases, in which the inclusion of more women on corporate boards (board diversity) and transparency on environmental liabilities were the most notable distinctions. The SRI Policy and UTAM overlapped in 83 decisions, ranging from more rigid executive compensation policies, independence for oversight bodies, environmental reporting, adoption of quantitative GHG goals, political contributions, anti-discrimination policies, and empowering shareholder voting. In all of these topic areas, UTAM made decisions that agreed with the SRI Policy but others that disagreed on the same subject matter.

From this data, the Subcommittee found that UTAM's outside investment managers were indeed engaging with ESG factors on occasion but their strategy was not clear. Even on similar resolutions, such as compensation transparency and GHG objectives, opposing views were taken on different firms. This difference could be attributed to an appropriate cost-benefit analysis of implementation, but also may reflect divergent investment philosophies of outside investment managers. It was the belief of the Subcommittee that a proxy voting guideline was needed to ensure that the ESG approach was standardized and managers' performance could be evaluated. However, UTAM reminded the Subcommittee that this data should be taken warily due to its small sample size.

The Subcommittee recommended that the Responsible Investing Committee (RIC):

1) Review the proxy-voting records of the top 50 holdings of the University each year;
2) Include the summary review of the proxy-voting records in its annual report;

These Recommendations are APPROVED by the RIC as of the End of 2009-2010

ACTIVITIES OF THE COMMUNITY OUTREACH SUBCOMMITTEE

1st Annual Town Hall

The Community Outreach Subcommittee organized a town hall on October 8, 2009. This allowed a chance for the RIC to present the background, purpose, makeup and areas of focus of the RIC to both university students and the broader university community. The RIC was able to canvass community interest in becoming involved with the RIC, encourage members of the community to join one of the three RIC subcommittees, and receive feedback from University stakeholders on the current direction of the RIC.

The Town Hall was organized into a panel discussion that introduced participants to the latest developments in responsible investment. The Town Hall hosted an excellent panel which included Eugene Ellmen of the Social Investment Organization (SIO), Bob Mann of Jantzi-Sustainanalytics, and Yulia Reuter of Riskmetrics. The panel discussed the composition and growth of the responsible investment industry in Canada, current responsible investment issues, the business vs. ethical/normative case for responsible investing, and how ESG factors are practically evaluated by industry professionals.

A closing Q & A period allowed the RIC to receive feedback on any issues which the University community felt were important and wished to discuss.

FUTURE STEPS

Assessment of the ESG Risk Methodology

In order to gauge the relevance and efficacy of the ESG risk framework adopted in 2009-2010, the General Policy on ESG Subcommittee will focus its research on a limited selection of 'key' ESG case studies that were identified as areas of overlap or divergence with UTAM:

Environmental

- Greenhouse Gas Emissions and Climate Change
- Standard Metrics for Environmental Transparency

Social

- OECD Guidelines for Multinational Enterprises
- Animal Rights – The Three "Rs" of Reduction, Refinement, and Replacement

Governance

- Executive Compensation – Say on Pay and Pay for Performance
- Board Diversity – Underrepresentation of Females and Minorities

These key ESG issues will be conducted by voluntary individual researchers, who will give arguments based on regulatory, legal, reputational, and operational risk. The Subcommittee's research will be directional in nature only. However, the objective is to fill in the University's knowledge deficit on ESG integration strategies in the following ways:

- Provide case studies to concretely evaluate the efficacy and relevance of a ESG assessment system based on the CFA risk criteria;
- Contrast proxy voting principles of existing institutional investors with the arguments that can be made for the material value implications of ESG factors;
- Provide a template research report for future ESG research at the University of Toronto on other ad hoc issues;
- Offer academic researchers insight into sources on ESG information and methods in which to synthesize this data into meaningful policy recommendations;

Statement of Investment Beliefs

In April 2010, the release of the Report of the President's Committee on Investment Policies, Structure, Strategy and Execution (the Jackman Report) was reviewed by the RIC for its impact on rethinking risk allocation, manager selection, and investment performance. One of the suggestions of the Jackman Report was to create a Statement of Investment Beliefs for the University. The RIC concluded that in 2010-2011 that a priority would be made to ensure that it contributed to any new Statement of Investment Beliefs and incorporated a commitment to the integration of ESG factors and more active shareholder engagement strategies.

Joining Shareholder Coalitions

The multifaceted nature of implementing responsible investment has caused the RIC to consider possibly expanding its resources by joining shareholder coalitions. This includes not merely issue-oriented coalitions, such as the Carbon Disclosure Project, but broad investor frameworks such as the UN Principles for Responsible Investment. The latter will be explored in depth in 2010-2011 for its wide-spread usage, with over 880 signatories, and the framework's ability to marry some concrete examples of ESG incorporation in investment decision-making and engagement opportunities with a holistic financially prudent investment philosophy.

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