

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

SRI via Environmental, Social & Governance Analysis



DERMOT FOLEY is the Manager, ESG Analysis, Mutual Fund Sub-Advisory, for Vancity Investment Management. He is responsible for analyzing the environmental, social and governance (ESG) policies and practices of companies held in the mutual fund subadvisory portfolios and working with them to manage their emerging ESG risk. Mr. Foley has more than 20 years of experience in social and environmental advocacy, research and policy analysis. Prior to joining VCIM, he was a Senior Policy Analyst on climate change for one of Canada's leading environmental organizations. Mr. Foley holds the Canadian Investment Manager designation and is a member in good standing of the CFA Institute.



STEPHEN MACINNES, CFA, is Director, Mutual Fund Sub-Advisory, for Vancity Investment Management. He has overall responsibility for the mutual fund subadvisory at VCIM. He manages the IA Clarington Inhance Canadian Equity and Monthly Income funds, and he co-manages the IA Clarington Inhance Global Equity fund. He has more than 40 years of experience in investment management. Prior to joining VCIM, Mr. MacInnes was the Chief Investment Officer and Head of Canadian Equities for HSBC Asset Management (Canada) Ltd. and M.K. Wong & Associates. He was also chosen as one of the 10 members of HSBC's elite global strategy group. Mr. MacInnes earned a bachelor's degree in business. He also holds the Chartered Financial Analyst designation and is a member in good standing of the CFA Institute.

SECTOR — GENERAL INVESTING

TWST: Would you give us a brief introduction to Vancity Investment Management, including some highlights from your history and your total assets under management?

Mr. MacInnes: Vancity Investment Management is a subsidiary of VanCity Savings and Credit Union, which is Canada's largest credit union serving the Metropolitan Vancouver area. We have over 400,000 members and in excess of \$15 billion in assets. Vancity Investment Management was founded in 1995 primarily to serve high net worth clients, small institutions, charitable foundations and now includes a mutual fund subadvisory, which provides services to IA Clarington, the sixth-largest mutual fund company in Canada. VCIM currently has over \$500 million in assets under management. The background to the mutual fund side is that in 2009 VanCity made the strategic decision to sell their in-house socially responsible funds to IA Clarington, who wanted to

broaden their own fund line up in Canada with SRI funds and provide non-SRI funds to VanCity. This is really a win-win situation for both sides. VanCity retains the SRI investment team and philosophy, and IA Clarington is providing SRI funds along with ancillary funds to VanCity members on an ongoing basis.

TWST: How would you describe your investment philosophy generally, and in particular as it pertains to the socially responsible funds?

Mr. MacInnes: Basically we have a responsible investment process. We seek and find companies that are leaders with progressive practices. We believe that by incorporating ESG — that is environmental, social and governance analysis — with traditional financial analysis, we can provide superior returns through an extra level of risk management and add alpha to the bottom line. By including ESG analysis as we take a deeper look into company balance sheets, we expose potential risks, highlight

strengths and strong leadership, to identify best-in-class practices, and determine how well a company discharges its corporate social responsibilities in regard to the four key stakeholders — shareholders, employees, customers and communities at large. We believe if a company executes this well, it all adds up to doing business better with less overall risk. Fundamentally we believe such companies are better managed, will be more profitable, and their shares will outperform in the long term. In our view, logically such quality and excellence can outperform.

TWST: Would you elaborate on how you incorporate socially responsible investing into your investment approach?

Mr. MacInnes: There are two aspects of responsibility. First, responsible management practice, which is the guiding philosophy of our parent. And secondly, Vancity Investment Management is the only firm in Canada whose SRI investment practice is fully integrated on site. This means the entire investment team — our ESG analysts led by Dermot and portfolio managers led by myself — buy into and understand this philosophy, working side by side on a daily basis to build portfolios collaboratively, 100% from the ground up. This is in contrast to the traditional outsourced model, whereby one team screens for SRI factors and transmits a list of potential investments to conventional portfolio managers who may have little understanding or even belief in those factors. Or the portfolio manager may take a conventional model, remove a couple of companies that don't make the SRI grade and then they call it an SRI model. We believe our integrated investment management process represents a competitive advantage in ensuring better-quality discussion and debates at all stages, and much faster, cleaner decision making.

TWST: It can be very easy for a company to say that it is socially responsible, but not hold itself to those standards. Considering your integrated approach, how do you really evaluate companies to ensure that they meet the criteria you've established?

Mr. Foley: We use seven performance criteria for our ESG analysis. We look at corporate governance, sustainable products, employee relations, diversity, community relations, environmental performance and human rights. We have 25 indicators that we examine under those criteria in total. We are looking at two key aspects of a company's ESG story: the company policies, and the actual performance or practices. For example, if a company has a goal or makes a statement that they want to address climate change and reduce greenhouse gas emissions, then we look at their actual performance and how it's disclosed and whether or not they have worked towards achieving those goals. Performance provides the best way of testing the story. Another example

would be diversity. Many companies say they have a commitment to diversity or that they are an equal opportunity employer. During our review we'll examine the company to determine the diversity of senior management and the diversity of the board. These indicators provide the best evidence to us and our investors that companies are living up to their stated commitments.

Highlights

Stephen MacInnes and Dermot Foley, money managers with Vancity Investment Management, discuss the criteria they use to make socially responsible investment decisions. They incorporate seven performance criteria in their ESG analysis — corporate governance, product sustainability, employee relations, diversity, community relations, environmental performance and commitment to human rights — and they use a bottom-up, multicap approach when selecting stocks. The team's stock-selection process starts with identifying companies in industries with positive conditions and reasonable barriers to entry. They then focus on companies with business models they understand and that have a sustainable competitive advantage. They use ROE, ROA and free cash flow to determine the profitability of the company. The team then looks at management's capital-allocation track record, near-term financial aspects and valuation. Mr. Foley and Mr. MacInnes also share insight on sectors that are likely to include companies that meet their SRI criteria, and the reasons they believe socially responsible companies can deliver above-average returns. Companies include: Church & Dwight Co. (CHD); Canadian National Railway Company (CNI); Procter & Gamble Co. (PG) and Johnson & Johnson (JNJ).

TWST: What is your sector allocation? And are there sectors, based on your experience, that are more likely to include socially responsible companies?

Mr. MacInnes: Let me just start off in terms of the conceptual aspect of our portfolios. As mentioned previously, our portfolios are largely built from the ground up, stock by stock. We have a little more of a stock-picking focus than a sector focus. This is particularly relevant for our Global fund where our sector considerations are certainly less important; however, as far as the Canadian market is concerned, sectors have a greater influence over our decision making. In Canada 75% of the market is concentrated in just three sectors — financials, energy and materials. So here, sectoral considerations do enter the picture, and top-down overlaying must be employed to a certain extent to provide the market-like returns as our investors expect in our Canadian fund.

So it is a little bit different between the Canadian situation and the Global fund. Normally we're still bottom-up stock pickers. And Dermot, do you want to address the socially responsible firms?

Mr. Foley: In general for the Canadian equity market, because there is such a high concentration of resource extraction companies, we place more weight on relative environmental performance and human rights practices. It's really important for us to know that an oil and gas company has an environmental management system, EMS, in place regardless of whether it's a small or large company. An EMS will help reduce the risk of environmental spills and fines. It doesn't eliminate those risks entirely, but we believe it makes operational risks more manageable. Similarly, if a Canadian mining company is involved internationally in areas where there are indigenous or aboriginal settlements, we need assurance that the company has policies in place covering security, human rights and community consultation. Otherwise company projects can be delayed or abandoned due to a failure to obtain consent and buy-in from local communities and authorities. As mentioned previously, we look at the company's track record to determine whether or not they're living up to those policies.

Mr. MacInnes: As a general comment, globally speaking and particularly in Europe, there is a much more fertile field for socially re-

sponsible companies versus North America. Certainly things are improving in North America; however, broadly speaking there are more and better alternatives within a global context.

TWST: Would you walk us through your stock selection process?

Mr. MacInnes: In addition to being SRI investors in conventional terms, our style is pretty much GARP, growth at a reasonable price. Our portfolios reflect the following characteristics. First of all, they're fairly concentrated but diversified across all sectors. We take a multicap approach; however, it's still predominantly a large cap, with 75%. The growth and profitability characteristics of the companies we invest in are generally higher than the market's. Similarly, yield is lower and valuation equal to or may be slightly higher than the market. All of which is consistent with a GARP orientation. In addition, all our holdings must meet our ESG and financial criteria for inclusion in the portfolio.

The fundamental or financial criteria we emphasize cover two key aspects — the business of the company, which is evaluated through four criteria, and secondly, whether the stock is attractive. In terms of the business criteria, we like companies that are in industries with positive conditions and reasonable barriers to entry. The second aspect is an un-

TWST: Some people might say that by investing in socially responsible stocks you may be leaving some money on the table. How would you respond to that?

Mr. MacInnes: Well, there is a considerable body of academic research out there which supports the notion that you don't leave money on the table. More importantly our own experience and results after many years of running money this way has pretty much proved that there is no sacrifice to return from SRI investing. In the end it still takes superior stock selection and skillful portfolio management to help outperform benchmarks and peers. SRI is not an impediment, and in fact should be additive over the long term.

Mr. Foley: And just to add to that, companies that have good environmental, social, and governance practices and corporate social responsibility performance can give themselves a competitive advantage. They can create very important barriers to entry. For example, companies in the retail fashion industry should have supplier codes of conduct and supply chain auditing systems, all of which help build the company's brand value and make it more difficult and expensive for a competitor to come in and take market share away. In this instance SRI can actually help a company remain more competitive.

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derstandable business model with some kind of sustainable competitive advantage. What are the key drivers to revenues? What are the key drivers to their expenses? The third aspect covers profitability measures. We're looking for above-average margins and profitability measures, such as return on equity, return on assets, and of course, a strong financial condition as measured through free cash flow generation and a strong balance sheet. And finally, we look at management and its track record and how it conducts itself in allocating capital. There are three ways a company can grow: organically, by acquisition or by distributing earnings to shareholders. We want to see how management has balanced those three aspects, historically and prospectively. After this analysis we can conclude whether we really like the business that the company is in, and whether we want to be involved in that company.

Then we move on to the near-term financial aspects, such as what does the outlook look like and what is the earnings growth going forward? Are analyst revisions positive? What are the catalysts to earnings growth and potential valuation? And then we look at valuation. This is where we build our own internal proprietary valuation analysis, which looks at a company, how it's guided historically over the past 10 to 15 years. We can usually get that much history. And then we will make a prospective projection as to how, on the same metrics, the company may be valued. We look at a high and low range, a risk/reward range going forward. We contrast and compare, and then rank companies on that basis. Obviously we want a favorable reward versus risk. At least a 2-to-1 ratio before we'll invest, and we update our evaluations periodically as developments occur. To sum up, if we like the company's business — there is a positive earnings outlook and valuation looks reasonable — then we will certainly buy it. We think good companies bought at reasonable prices should outperform in the long run.

1-Year Daily Chart of Church & Dwight Co.



Chart provided by www.BigCharts.com

TWST: Would you give us a couple examples of your holdings that you believe exemplify both your general investment approach as well as your focus on SRI?

Mr. Foley: Church & Dwight (CHD) is a great example. They have very strong commitments to sustainability. They produce products that are available throughout the home, everything from toothpaste to baking soda, laundry detergent and kitty litter. The company has a long-term commitment to social responsibility, which is demonstrated by producing environmentally friendly products. They use life-cycle benchmarking scores to look at energy use, water use, waste production for the entire product. And they have sustainability objectives built right into their business model. Over the past five years they've had excellent annual sales growth, partly due to their positive reputation and the types of environmentally friendly products they sell.

Another good example is **CN, Canadian National Railway** (CNI). Rail transportation in Canada moves over 65% of all freight, but accounts for only 7% of the greenhouse gas emissions from freight transportation. It's a very efficient means of moving goods throughout the country. On average it requires only 25% of the energy that's used for heavy-duty trucking. So we see CN as an example of sustainable transportation. In addition, they are committed to investing in improvements for their fleet of locomotives, increasing fuel efficiency through engine replacement and remanufacturing. So CN is a great example of a company that demonstrates a commitment to sustainability and offers benefits from a social responsibility perspective as well.

1-Year Daily Chart of Canadian National Railway Company



Chart provided by www.BigCharts.com

Now in terms of stock, earlier in the year we eliminated **Johnson & Johnson** (JNJ). Its fourth-quarter results were again disappointing. **J&J** really has suffered and continues to suffer from a number of product recall notices, which along with disappointing Q4 results convinced us that the business is operationally having some difficulty. It gave us a lot of concern about the way the company is operating, its quality control and its ability to execute. We not only — and unfortunately it's also in their outlook — suggest that many of the issues which dragged the company down in 2010, such as the overall economic pressure, European Union austerity programs and U.S. health care reform and taxes are still going to be troubling them in 2011. They are going to suffer some generic drug hits on a couple of their drugs. Earnings expectations have been coming down for some time, which continued unabated, have matched a continuing erosion of profitability. This in turn is driving a valuation compression for the company. So adding it all up, it's the reverse of companies we like, kind of lacks momentum on the fundamentals — in fact may be negative. Earnings expectations are falling, and we have a kind of an unfavorable risk/reward ratio on our valuation. So it all added up to, "It's time to sell."

TWST: All things considered, what type of investor would make an ideal client for Vancity?

Mr. MacInnes: I would say an investor who has a conscious awareness of the potential impact from environmental and other social factors affecting the way companies operate, but realizing no company is perfect. An investor who wants to gravitate to an investment management style which complements his or her beliefs, while achieving investment goals and competitive returns in the long term.

Mr. Foley: Rail transportation in Canada moves over 65% of all freight, but accounts for only 7% of the greenhouse gas emissions from freight transportation. It's a very efficient means of moving goods throughout the country. On average it requires only 25% of the energy that's used for heavy-duty trucking. So we see CN as an example of sustainable transportation.

Mr. MacInnes: On the financial side I'll briefly describe why **Church & Dwight** has been a long-term holding in our global fund. The company is predominantly a North American consumer-goods producer with a tremendous ability to grow and acquire brands in niche segments. They kind of stay out of the way of the big players like **Procter & Gamble** (PG), and yet they are very, very profitable. It's had 20% growth in earnings over the last 10 years-plus. Dividends have grown every year by about 13%. Generally it has the high margins we are looking for, near-double-digit margins, and comfortably in the 15% range on a very unleveraged balance sheet. In all it's a really well-managed company, and it's been very adroit at growing its products over time. The stock is a little expensive now in terms of valuation, and we may have trimmed back some on our sell discipline.

Even though we still may like a company and the fundamentals may be intact, if according to our valuation, it gets very expensive, then we'll certainly take money off the table; however, we won't necessarily eliminate the position. Conversely, we usually use those proceeds to buy stocks where the fundamental model is still intact, but for some reason may be having a short-term problem or be out of favor. Our investment process involves harvesting profits on fully valued stocks and adding weight to undervalued ones.

Mr. Foley: It's very important that the type of investors that come to Vancity — or to the IA Clarington SRI fund family — are investors who understand that socially responsible investing will help to sustain your wealth-generating power and allow you to invest in companies that are contributing to more sustainable economy, and a more sustainable society.

TWST: Thank you. (MES)

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