DEGROOTE SCHOOL OF BUSINESS - MCMASTER UNIVERSITY

RESPONSIBLE INVESTING IN THE RETAIL ADVISORY CHANNEL

CONTENTS

EXECUTIVE SUMMARY

This report presents findings and insights from in-depth interviews with over 100 financial advisors, investors, and financial industry professionals over the last 3 years.

Responsible investing is the “incorporation of environmental, social and governance factors into the selection and management of investments”. You will learn in this report that responsible investing means different things to different advisors and investors.

Investing more responsibly is gaining more investor attention. In its most recent report, the Responsible Investment Association of Canada (RIA) found that 75% of investors wanted their advisors to inform them of responsible investment options; however only 28% of respondents had.

For some investors responsible investing eases their conscience by excluding undesirable firms from their investments while participating in the global economy. For others, it is a means of “voting with their dollars” and driving meaningful change with respect to how firms address societal challenges. We found some financial advisors keenly interested in providing advice grounded in responsible investing principles. However, many financial advisors were uncertain regarding the full extent of responsible investing and what it means for different investors.

In this report we

- Highlight what responsible investing means to investors as well as to advisors. In the process we unlock some of the lexicon used.
- Following this, we explore the motivations that investors and advisors have in adopting a responsible investing approach.
- Detail the practices that investors and advisors use when engaging in responsible investing.
- Address preconceived notions around responsible investing.

We thank the advisors and investors that we talked to, and the organizations that facilitated these contacts. Without their time, attention, and candour, none of this would have been possible.

ABOUT THE RESEARCH TEAM

Brent McKnight is an Associate Professor of Strategic Management at the DeGroote School of Business, McMaster University. Dr. McKnight studies how firms and organizations address complex societal problems. Currently this interest has led him to undertake research in the area of responsible investing at the retail advisory level.

bmcknight@mcmaster.ca

Kevin Veenstra is an Associate Professor of Accounting at the DeGroote School of Business, McMaster University. Dr. Veenstra studies the influence of social norms and personality traits on an assortment of phenomena, including career trajectories and corporate financial performance. His interest is driven by his fascination with how individual and group characteristics influence decision making and related outcomes.

Benson Honig is the Teresa Cascioli Chair in Entrepreneurial Leadership, DeGroote School of Business, McMaster University. Research interests include business planning, nascent entrepreneurship, transnational entrepreneurship, ethics in scholarship, immigration and social entrepreneurship, social capital, and entrepreneurship in transition environments. He has published in leading academic journals (over 100 peer reviewed articles) and serves on ten editorial boards.

Anjali Chawla is a PhD Student of Organizational theory at the DeGroote School of Business, McMaster University. Her research interests include sustainability and social entrepreneurship.

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WHAT IS RESPONSIBLE INVESTING?

Investors and advisors understand responsible investing from different, but compatible perspectives. This understanding is akin to the parable of the blind men and the elephant. In this story, a group of blind men encounter an elephant. Each man touches a different part of the elephant; a tusk, tail, hide, etc. and each describes a very different animal. In a similar way, responsible investing means many different things to different investors and advisors.

Responsible investing refers to a series of tactics, approaches and/or philosophies associated with making investments of a particular type or in a particular manner. At its core, responsible investing refers to an awareness pertaining to the impact of one’s investments.

INVESTOR CONCEPTUALIZATIONS OF RESPONSIBLE INVESTING

Investors think about responsible investing in three different ways. We label these Keeping Hands Clean, Voting with Dollars, and Pushing the Corporate Agenda. These categories may not be exhaustive and investors were, in most cases, also very interested in financial returns as well.

Keeping Hands Clean
Investors sought to avoid being associated with firms that engaged in disagreeable practices.

Many investors took an exclusionary approach to their investing, often combing through their investments and the lists of firms held by mutual funds to identify objectionable firms. These exclusionary screens were sometimes sector based. For example, they referred to entire industries – the so-called "sin" stocks such as gambling, alcohol or tobacco. The fossil fuel and defense industries were other sectors that investors avoided.

At other times, investors focused on particular firms. These exclusions often drew from their own belief systems or experiences with the firm. Facebook, for example, was a commonly mentioned firm that was excluded on the basis of privacy issues.

[Y]ou'd be looking at investing away from investments that, in your opinion, do societal harm. -Investor 96

Keeping Hands Clean also reflected investor's concerns with engaging in the stock market in general. Some investors expressed anxiety and concern about the ability to find investments unassociated with undesirable practices.

[I]t's really hard to do ... and many times I think it would be better to just put, and it sounds stupid, but put your money in a mattress because you absolutely do not want to be a party to practices that actually are not congruent with your values. - Investor 23

Voting with Dollars

Some investors identified with the idea of using their investments to bring about the solutions they wanted to see in the world.

[I]t's going along with your own personal ethics and what you are like and ... how you want your society, your country to be shaped. - Investor 74.

Often this was climate change solutions or supporting women in senior leadership positions by investing in mutual funds with these outcomes as stated objectives. At other times, it meant buying individual stocks with a reputation for pursuing these objectives such as Tesla, Beyond Meat, and Patagonia. These investors voted with their dollars, supporting the firms that were engaging in the practices that were part of their world view.

"Investing in companies that are going to have a positive impact on the world." - Investor 115

I've been an environmentalist [all my life] ...we get to vote every time we spend a dollar. So I kind of grew up on that punk rock ethos. - Investor 17

Pushing the Corporate Agenda

Other investors were interested in pushing firms to engage in more pro-social or pro-environmental practices. Individual investors lack this influence so this strategy requires investing in a mutual fund that has a stated shareholder engagement strategy. This approach was more common in the credit union system due to its close association with NEI. NEI is a mutual fund company, and one of only a handful in Canada with a well defined and active shareholder engagement strategy (also see VanCity's engagement strategy)

Investors found these approaches to responsible investing appealing, but rarely engaged in them equally. A few highly committed investors engaged in pushing the corporate agenda. Voting with Dollars and Keeping your Hands Clean often worked hand in hand.

Investors found it difficult when they expressed a strong palpable need to avoid specific firms or sectors that overrode other concerns, and made it challenging to find mutual fund or ETF products.

A good example of the struggle to exclude undesirable firms is the tendency for responsible investments to be heavily weighted to technology solutions such as Amazon, Facebook and others that come with their own issues around privacy, carbon, and community impacts. For others, pushing the corporate agenda meant giving up an exclusionary approach in favour of shareholder engagement practices.

This approach was not for everyone. At least one investor felt that shareholder engagement was an inappropriate overreach for investors, and unduly influenced a firm's ability to make their own choices.

Responsible Investing at its Core

At its core, responsible investing appears to be more about information and empowering investors to greater understanding. This was a theme that appeared central to the definition of responsible investing.

I think what it means to me is having enough knowledge to know where the money that you're putting into these companies is actually going - Investor 118

WHAT RESPONSIBLE INVESTING IS NOT

Investors struggled to communicate the difference between conventional and responsible investments; the line separating them was blurred. Investing in Amazon was a great example. While this stock is held by many responsible investment mutual funds, many investors argued that their extensive use of fossil fuels and over-packaging were unacceptable.

Regardless of approach, this created quite a bit of stress for investors. Those who were seeking to exclude sectors or firms struggled with what was acceptable to invest in. Central to this is that different people find different sectors and practices more or less acceptable. This is based on the individual's specific values, life experiences, and point of view.

It really depends on where your threshold is for responsible. And I know I drive myself crazy if my threshold is always at the top. ... for me to not drive myself crazy, I have to say, yes, like it's responsible. Chill out about it. - Investor 74

Every investor we talked to agreed that it was not possible for an investment to be 100% responsible.

This difficulty in defining responsible investing makes communication between advisors and investors challenging. Without common ground, it is difficult for investors and advisors to come to an understanding about responsible investing and how it should manifest in a client's portfolio.

ADVISORS EXHIBITED INCOMPLETE UNDERSTANDING OF RESPONSIBLE INVESTING

Advisors who provided advice pertaining to responsible investing appear to cluster into three categories.

Passionate about Environmental and Social Issues

The first group of advisors is extremely passionate about environmental and social issues. This passion is reflected in their advising practice. Advisors in this category often restricted clients to those keenly interested in responsible investing.

We heard from these advisors that they "think responsible investing is helping the companies that want to see the world a better place to grow (Advisor 37)" and that their clients "... want to make a difference to the planet that they're on. And their way of doing it is through their dollars. (Advisor 38)"

Risk Mitigation

A second group of advisors appreciated the additional risk analysis associated with responsible investing practices. For these advisors, responsible investing, and in particular the integration of environmental, social and governance (ESG) indicators, amounted to added analytics and double checking the suitability of investments.

So it's really an additional lens through which we evaluate investments. So it goes beyond - Advisor 10

This approach to mitigating risk is connected to how responsible investment is often viewed in the institutional investment world. There, responsible investing plays the important role of ensuring firms are not engaging in practices that could lead to operational, reputational, or other risks that would have material impacts on the firm's financial performance.

At times, this focus on risk drove a misunderstanding regarding responsible investing. Some advisors conceptualized responsible investment as an investment class in its own right and sought exposure to it in the same way one would seek exposure to an equity or bond market. The strong performance of some firms associated with sustainable solutions such as Tesla and Beyond Meat has propelled some of this practice.

ADVISORS EXHIBITED INCOMPLETE UNDERSTANDING OF RESPONSIBLE INVESTING

Value Alignment

A third group of advisors sought to reflect their client's values through their investments. These advisors recognized responsible investing as a very personal practice. When asked what responsible investing was, one advisor remarked "Oh, that's a great question, because I feel that responsible investing is gonna be very subjective. It's gonna be very personally biased, right? (Advisor 67)". For these advisors, responsible investing is about finding investments and investment products that "align with a client value system (Advisor 19)" and allow investors to "put [their] conscience first before [they] buy something" (Advisor 19).

However, few advisors fully captured the breadth of possibilities associated with responsible investing. Rather, advisors tend to pick one or sometimes two aspects of responsible investing when engaging with clients . This means that most clients are being informed on a narrow slice of the responsible investing universe.

At its best, responsible investing empowers investors, enabling them to meet their financial goals in ways that make the most sense to them.

For advisors, this means understanding and connecting with investor's varied motivations. Advisors can put investors in the driver seat when advisors hold a more holistic understanding of responsible investing approaches. This was often missing.

[W]e are going to have to be more client centered. [Responsible Investing] would be something, I would hope would be on a priority list. - Advisor 80

RESPONSIBLE INVESTING LEXICON

Advisors and investors alike struggled to demonstrate a working understanding of common responsible investing lexicon. We discussed responsible investing terms such as environmental, social and governance (ESG), negative screening, positive screening, shareholder engagement and impact investing. Advisors did better than investors at defining these terms, but there was a general lack of understanding and even confusion associated with key responsible investing terms.

A lack of shared lexicon makes communication between a financial advisor and client difficult.

Responsible Investing Lexicon

The following are definitions of five key terms that responsible investors and advisors should know. Knowledge of these terms helps to provide a stronger understanding of the scope and scale of responsible investing.

ESG - Environmental, Social and Governance

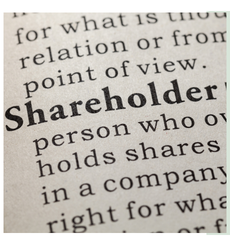
Refers to three categories of factors used to measure how the firm contributes to sustainability or community impact. Environmental factors may include energy use, waste and treatment of natural resources. Social criteria refers to relationships such as with suppliers, communities, employees, and customers. Governance refers to the ways in which stockholder's ownership is manifest in decision making and compensation processes at the company.

Negative / Exclusionary Screen

Involves excluding companies that fail to meet a pre-established set of criteria. Examples include so-called "sin" stocks where companies profit from alcohol, tobacco, or gambling but may include other exclusions such as involvement in fossil fuels.

Positive Screening

Selecting firms for investment that demonstrate pro-environmental or pro-social practices. Examples include best-in-class firms from industries commonly considered "dirty" or more generally seeking out companies that contribute positively to the community in some way.



Shareholder Engagement

Refers to how shareholders can influence a company's behaviour through persuasive tactics, proxy voting, and divestiture. Increasingly, institutional investors, including mutual fund companies, are using their financial clout to push for behaviour change.

Impact Investing

Investments made into organizations with the intention of generating measurable social and/or environmental impact alongside a financial return.

MOTIVATIONS FOR RESPONSIBLE INVESTING

Advisors

Most advisors that we talked to felt a strong sense of purpose. Often this was connected to a desire to connect with people. A few really RI-engaged advisors have strong pro-social and/or environmental motivations that drive their engagement in responsible investing.

We found that credit union advisors are significantly more interested in responsible investing. A key reason for this is that they are affiliated with a fund company with a strong focus on responsible investing. Credit unions tend to also have a stronger community-feel that might attract a particular type of advisor. Regardless of the organization that an advisor works for, the motivation for responsible investing can develop over time.

I don't think I just woke up when I started my investment career, you know, that (RI) was my primary objective because it wasn't. But as I've sort of learned more about it, ... it's really opened up that motivation within myself. - Advisor 86

More holistic financial planning processes helped unearth client preferences. This led to expanded conversations including discussions about responsible investing.

"[W]e ask people if they're interested in social responsible investing. ... So it allows us to bring [responsible investing] into every conversation if you're selling mutual funds to someone." - Advisor 71

For some advisors, translating strong motivation for responsible investing into sales success means tailoring their “sales pitch” to the audience. One advisor described using risk-based framing, as opposed to values-based framing, when pitching to clients that were professionals. Another advisor explained the importance of being flexible and letting the client lead the conversation.

We meet so many different people...And it can go on more of a risk reduction ... conversation, but it can also go into more of a shareholder engagement conversation. So [it] really depends on what will stick with the member. - Advisor 128

Like individual investors, many advisors with a strong focus on responsible investing had significant formative experiences. These included community-minded parents, visits to developing countries, and challenging upbringings. These led many advisors to want to make positive change.

When I was in my thirties, I went to Africa ... and saw many kids impacted by AIDS there and so decided to do my own research at that time and look for investments that sort of aligned with my values. - Advisor 71

Interestingly, there were some advisors who took a more pragmatic approach to adopting responsible investing in their practice. For them, providing responsible investing advice to their clients was simply “good for business”.

I've been relatively agnostic [about RI]. I'm just trying to make people money. That's essentially the first and foremost. And secondly, if you could do it in a good way. That's what I want. - Advisor 52

We also found a clear link between advisor's personal values and the intensity of responsible investing in their practice. Advisors who personally invested responsibly were highly concerned about social and environmental issues. They were significantly more likely to host information sessions on responsible investing with clients and engage in more sophisticated responsible investing strategies including theme-based investing, shareholder engagement, and impact investing.

Investors

Investor interest in responsible investing often stemmed from formative experiences. These included education in disciplines such as environmental studies and forestry, trips to developing countries as teenagers, or the reality of environmental disasters in the countries from which they immigrated.

So I say from childhood... a huge emphasis on volunteering. - Investor 90

I traveled to ... underprivileged areas...when I was 15, 16, 17. And that disparity was really hard for me to comprehend... I told myself, when I get to the point of when I can invest, I want to be able to affect some kind of change with it. - Investor 74

Consistent with expectations, there was a tight connection between interest in RI and vocation for many individuals.

[S]omething that I'm actually really passionate about is women and leadership. I am on the leadership board for the Women's Network at [organization]. ... So it did trickle into my investments. - Investor 110

In many cases, there was a tight connection between their formative years and their interest in a particular facet of RI.

My father is from Jamaica ... and there's concern in terms of the lack of access and infrastructure to provide water... so I think it's just a lot of subconscious things. - Investor 127

Interestingly, for a few investors we spoke to, responsible investing was a way to ameliorate negative associations with wealth, capitalism, and/or corporate misbehaviour. Surprisingly few investors linked their interest to their religious beliefs and/or practices.

I didn't grow up with any kind of wealth. So having wealth is kind of a little bit of a burden to me ... I feel pressure to do something good with it. - Investor 90

I think probably (responsible investing for me personally) would start in my industry... I think that's the piece that I probably hold a little bit of guilt. Over the last 20 years, I think we've been one of the most offending industries in the world. - Investor 100

A common theme in many discussions with investors was the notion of “doing good by doing right”.

I think for me, [responsible investing] is not just [to] make money, but to feel good while doing it. - Investor 123

A few of the investors we talked to were relatively apathetic toward responsible investing. Much of this apathy stemmed from the belief that “one voice” cannot make a difference or that responsible investing comes at a cost of lower expected returns.

With my friends, there's a lot of apathy, not around the mission, not around the causes, but around the investors’ individual ability to make a change. - Investor 111

PERSONALITY TRAITS IN RETAIL ADVISING

Following interviews, we asked advisors to complete a personality assessment. This survey assessed six dimensions of personality including honesty/humility, emotionality, extroversion, agreeableness, conscientiousness, and openness to experience. This is the Hexaco personality model.

Personality and Advising Practices
We found that advisors who were more engaged in responsible investing tended to score higher on levels of honesty/humility as well as extroversion. Honesty and humility are values-based personality traits that align well with the aim of responsible investing for many investors.

The association between responsible investing and extroversion may reflect the need for advisors to more actively engage clients on the topic. More introverted advisors may be reluctant to engage on this sometimes sensitive topic.

Interestingly, older advisors were more likely to be personally invested in responsible investing and to be drawn to social issues. As people age, we noticed a weak association with higher levels of honesty and openness to experience. The presence of these personality traits may account for the presence of older advisors in our sample, despite the widely held notion that responsible investing is the vanguard of younger generations.

RESPONSIBLE INVESTING PRACTICES

Investors often distinguished between two pools of funds. The first pool was larger and associated with long-term retirement oriented investments. These funds were typically invested with a financial advisor or in mutual funds and ETFs.

The second pool was described as “play” money. These monies were placed in investments of particular personal interest to investors and often better reflect responsible investing. One tech entrepreneur had a largely tech focused portfolio, staying away from oil and tobacco. A manager in the fashion industry was attracted to investments like Patagonia and Columbia Sportswear with strong environmental records.

We think the reasons for these different approaches to investing is multi-fold. First, investors implicitly viewed responsible investing as riskier and thus put retirement investments in more conventional products, Second, investors often made “play” money responsible investments without their financial advisor. This is curious since "riskier" investments should benefit from professional advice. Our discussions with investors suggested that investors were struggling to discuss responsible investments with their advisors.

It was that second pool of “play” money through which investors often discussed making investments that they described as more responsible.

THE IMPACT OF ADVISING APPROACHES

We found that how advisors approached their practice had a significant impact on the nature of their responsible investing advice. In some cases these impacts reflected clear preference that the advisors espoused, whereas in others they represented inherent restrictions based on the advisor's organizational environment.

Mutual Funds and Products
Advisors who preferred or were restricted to selling mutual funds effectively outsourced their responsible investing to the fund managers and thus were limited by their product shelf. The very real challenges for these advisors are time and attention to understand responsible investing funds at the detail required.

Summarizing this approach, one advisor noted that their job was not to "spend your days doing all your own research", but rather "tap into some great resources thoughtfully for the purpose of better managing relationships and attracting new assets to the firm (Advisor 60)."

Mutual funds offer investors access to shareholder engagement strategies that are difficult to achieve as an individual investor. They also can present a collective vision of an investment around specific themes.

Stocks and Bonds
Advisors who engage actively in picking securities for their clients tend to drive their own flavour of RI based often on their own interests. These advisors often consider themselves the expert on RI decisions. One advisor related that "I know in my head. Just from being very conscious of this for years and years and years which companies are actually doing it ... just from my own personal knowledge (Advisor 47)."

If an advisor adopts this approach, investors need to buy into the flavour of responsible investing that the advisor is adopting.

An advisor's preference for products or securities influences how they can achieve an investor's responsible investing goals.

Advisors as a Gate Keeper

Advisors function as a gate keeper with respect to responsible investing. This makes them critical actors for investors who are seeking responsible investment solutions. Investors should look to match their level of interest in and approach to responsible investing with that of their advisor. For those who are passionate about responsible investing, finding an advisor with a similar approach is likely going to make it more comfortable.

We heard that advisors often struggled to have conversations about topics where they had less knowledge or interest: "…you know, the Greta article or whatever, I don't want to talk about that (Advisor 85)." In financial institutions, many branches have at most a handful of advisors who are really bought into responsible investing.

No, I don't think so. I don't find it very challenging [pointing clients toward RI]. Actually, for the most part, people, you know, for those that don't care, they are like sure buy me some. It sounds it's in the news. It's probably gonna be fine. But they don't necessarily care or want ESG investing. But I can …I can convince them that they should have part of it because it's another one of the sectors out there that you should be part of. - Advisor 47

PRECONCEIVED NOTIONS REGARDING RESPONSIBLE INVESTING

Advisors

The advisors we talked to agreed that recent, increased product availability has removed the historical performance disadvantage of responsible investing. Yet concern over performance remains for some investors and advisors.

Interestingly, many advisors expressed concern about being "considered radical" or "coming across as judgy", leading to putting-off prospective clients and even turning away existing clients.

Yeah, up until about 18 months ago, they weren't doing very well. - Advisor

There's still a lot of skepticism out there, especially in my area, especially among [male advisors]. - Advisor 50

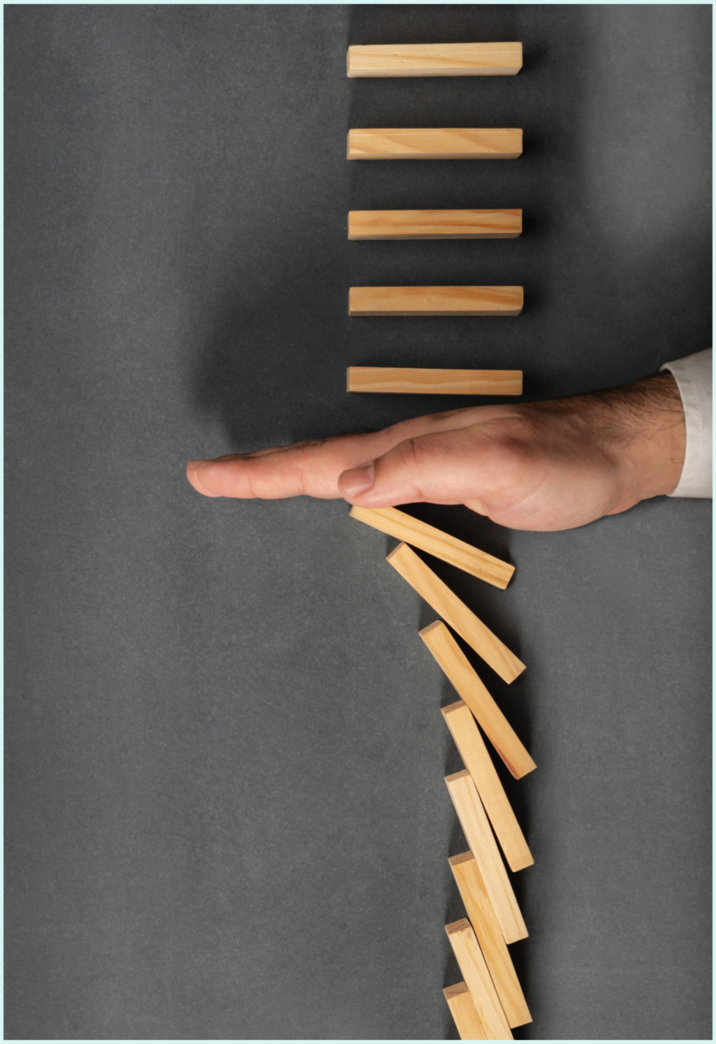
I can't speak for others, but I suspect ... a lot of people don't want to get into arguments with their clients and sort of be preachy and holier than thou about things. So that's probably what holds people back. - Advisor 50

Many advisors explain responsible investing to clients as a risk reduction strategy rather than from a value alignment perspective.

The role of responsible investing in my practice is a risk mitigation tool ... A responsible investment company looks at price to earnings ratio, but they also say what happens if a company that you hold in your portfolio runs a sweatshop...that will have an impact on the bottom line of Joe Fresh in this case. That is a risk mitigation tool to someone who wants to make money. - Advisor 78

The demand for responsible investing has increased significantly over the past few years, due in large part to increasing prevalence/transparency in reporting of environmental and social issues. Many individual investors now view climate change as an existential threat and want to help environmental initiatives with their investing dollars.

I've a lot more thoughtful questions with some people now. They're looking at life differently. I think they place an importance maybe on some different things now. - Advisor 71



Investors

Investor concern regarding potential greenwashing leads to a lack of meaningful engagement with responsible investing. Investors expressed awareness of false ESG claims and critical analyses of firms and investments. Investors were critical of the disproportionate amount of effort some companies place on marketing their ESG initiatives versus allocation of real effort and resources.

I just think that what's worse for me than doing nothing is saying you're going to do something and not doing it well. - Investor 73

All investors we spoke held the strong belief that there is no such thing as a 100% responsible investment. However, this belief alone did not prevent most of them from investing responsibly.

I don't think there's any company out there that is completely altruistic....they need to be profitable as well. So I think there is a lot of gray in terms of defining what is responsible versus not. - Investor 104

This skepticism was reflected in a desire for familiarity with the investment being made.

And so I would say the one thing for me is, depending on where I've worked at... companies that I've seen, I'm more willing to invest in them. - Investor 118

A handful of investors we spoke with saw substantial overlap between responsible investing and philanthropy. This influenced investing behaviour. Some investors even sought to maximize their profits through conventional investments and then subsequently make charitable contributions.

A common misconception was that responsible investing always came at the cost of lower expected returns. This misconception persists for some despite evidence to the contrary.

I don't think you can have both worlds. I think you can either try to make as much money as possible or you can try to do good. Probably can't do both. I think it would be lightning in a bottle if you found a portfolio where everything was responsible and performed the same level as the market. - Investor 125

Investors who believed in the financial value of responsible investing often felt that the returns came over the longer term.

Investors struggled at times to reconcile lifestyle choices with investments. For instance, some investors were reluctant to exclude fossil fuel-based stocks from their portfolios when they drove and used fossil fuels in their day to day.

I've never considered [excluding] oil, but I do think that, you know, it is a finite resource. But at the same time, it's an industry that is necessary. So should everyone pull their money out? I don't think so either. - Investor 112