Vancity Investment Management Insight

RESPONSIBLE INVESTING NEWSLETTER – JULY 2017

Vancity Investment Management

iA Clarington™ Investments
be invested

Reconciling the past: Building an inclusive future

Canada's banks provide a vitally important function in the economy as major sources of capital and as intermediaries between investors and developers. In many instances, resource extraction projects could not proceed without investment banking services or debt financing. To ensure funded projects do not violate human rights or engage in environmentally destructive practices, banks need to exercise enhanced diligence. The Equator Principles are a key tool used by banks to encourage sustainable development while minimizing social and environmental risks associated with major projects. On a global basis, 90 banks and other financial institutions, including most of Canada's banks, apply the Principles when assessing projects with capital costs of at least US$10 million. Major fossil fuel pipeline projects in Canada and the U.S. point to the need to update and harmonize the Principles and to ascertain whether future clean development pathways are compromised by today's infrastructure developments.

A coalition of First Nations and environmental organizations recently called on banks to decline financing for Kinder Morgan and the Trans Mountain Pipeline Expansion project. The coalition raised a number of concerns and highlighted the link between project finance, reputation risk and environmental risk. While the Inhance SRI funds do not hold Kinder Morgan or Trans Mountain Pipeline securities, we do invest in Canadian and other banks who are involved in project finance activities.[1] On behalf of the funds, we requested that Canadian banks apply a higher level of diligence over potential environmental and social impacts from the project. In particular, we expect financiers to ensure that project developers obtain the free, prior and informed consent (FPIC) of indigenous people who may be affected by the project. We believe FPIC is necessary to address the imbalanced historic relationship between corporations and indigenous groups. Our support for FPIC is grounded in the Equator Principles, the United Nations Declaration on the Rights of Indigenous People and the Truth and Reconciliation Commission of Canada.

EQUATOR PRINCIPLES

The Equator Principles are designed to ensure that financial institutions that provide or facilitate funding for large projects are not complicit in significant negative social and environmental impacts. With respect to social impacts on indigenous people, the Equator Principles explicitly reference International Finance Corporation (IFC) performance standards on the need for FPIC by affected aboriginal groups:

> Projects affecting indigenous peoples will be subject to a process of Informed Consultation and Participation, and will need to comply with the rights and protections for indigenous peoples contained in relevant national law, including those laws implementing host country obligations under international law. Consistent with the special circumstances described in IFC Performance Standard 7 […], Projects with adverse impacts on indigenous people will require their Free, Prior and Informed Consent (FPIC).

Principle 5: Stakeholder Engagement, Equator Principles III, June 2013

The Equator Principles have recently come under criticism for applying a double standard to projects in North America. The current version of the Principles considers compliance with host country laws as an adequate means of managing social and environmental risk and does not apply IFC performance standards. For the Trans Mountain Pipeline Expansion project, this means the findings of the National Energy Board are considered by Canadian banks to adequately address these risks.

Given the large amount of territory claimed by indigenous people and the large amount of resource development occurring in North America, we believe relying on host country regulators creates undue reputational risk and project-specific risk for financial institutions involved in funding major projects. Because of the failure to achieve FPIC for the Dakota Access Pipeline project process, a number of EU-based banks are suggesting that IFC standards should apply to all projects. We support this proposal and have called on Canadian banks to voluntarily apply the IFC standard to projects they intend to finance or for which they provide advisory services. We believe this would help facilitate reconciliation with indigenous people and be consistent with evolving government policy as noted in the United Nations Declaration on the Rights of Indigenous People.

UN DECLARATION ON THE RIGHTS OF INDIGENOUS PEOPLE

The UN Declaration on the Rights of Indigenous People was adopted in 2007 by the UN General Assembly, with four countries voting against – including Canada. The government at the time was opposed to the requirement to seek consent from indigenous people, in particular Article 18 of the Declaration:

> States shall consult and cooperate in good faith with the indigenous peoples concerned through their own representative institutions in order to obtain their free, prior and informed consent before adopting and implementing legislative or administrative measures that may affect them.

In 2016, following a change in government, Canada officially adopted the Declaration and announced it would be fully supported and implemented, in accordance with the Canadian constitution, which protects indigenous and treaty rights. The change in position and policy is partly in recognition of the need for reconciliation between Aboriginal and non-Aboriginal Canadians.

THE TRUTH AND RECONCILIATION COMMISSION OF CANADA

Reconciliation is a major issue in Canada and is likely to influence resource development decisions for the foreseeable future. Reconciliation arose out of a need to address discrimination against indigenous people in Canada. For over 100 years, starting in 1867 with the founding of the nation, the government of Canada sought to eliminate traditional aboriginal culture, language and identity through a policy of assimilation and integration. Compulsory schooling and residential schooling, which removed children from their families and communities, were instrumental in attempts at forced assimilation. In recognition of the harm and abuse caused by residential schools, the Truth and Reconciliation Commission of Canada was established in 2008. The Commission provided a response to the legacy of Indian Residential Schools, acknowledging injustices and harms experienced by indigenous people and the need for continued healing. The Commission found that the UN Declaration on the Rights of Indigenous Peoples "provides a valuable framework for working towards reconciliation between Aboriginal and non-Aboriginal Canadians."[2] In 2015, the Commission called on the private sector to adopt the Declaration:

> We call upon the corporate sector in Canada to adopt the United Nations Declaration on the Rights of Indigenous Peoples as a reconciliation framework and to apply its principles, norms, and standards to corporate policy and core operational activities involving Indigenous peoples and their lands and resources. This would include, but not be limited to, the following:

> Commit to meaningful consultation, building respectful relationships, and obtaining the free, prior, and informed consent of Indigenous peoples before proceeding with economic development projects.[3]

THE TRANS MOUNTAIN PIPELINE EXPANSION PROJECT

Currently, more than a dozen First Nations are challenging the legality of Kinder Morgan's Trans Mountain Pipeline project and some have issued a call for divestment from institutions who fund the project. We are concerned that financiers have not obtained FPIC or adequately considered how the project is imposing environmental and human rights risk on First Nations communities.

The original right-of-way for the pipeline was obtained by Trans Mountain Pipeline in the early 1950s. At the time, Canada still held to a policy of assimilation. As a result, indigenous people could not launch a legal claim to rights or title that would challenge the Canadian government; nor could they rely on Members of Parliament to represent their views since, prior to 1960, indigenous people could not vote in parliamentary elections unless they gave up their treaty rights and Indian status. A significant aspect of the Reconciliation process is the need to redress historic wrongs and establish a new relationship with First Nations based on mutual respect. We believe achieving FPIC for the current pipeline expansion project, which primarily uses the original right-of-way, will help reconcile the historic imbalance between project proponents and indigenous people.

CONCLUSION

Relying on regulators to determine whether the Trans Mountain Pipeline Expansion project complies with the Equator Principles is a risky decision that has the potential to negatively impact each participating bank's reputation. In April 2016, the National Energy Board released its report on the project and concluded that impacts on the interests of indigenous people were insignificant. The analysis supporting that conclusion was strictly limited to traditional use, traditional knowledge and traditional purposes. While an assessment of traditional use may be of value in establishing an indigenous right to a territory, it does not reflect the uses to which that territory could be put in order to meet the ongoing aspirations of indigenous people, who may wish to practice their own forms of sustainable development. It is based on a "frozen in time" assumption where indigenous people who pursue traditional uses and rights cannot evolve to reflect current or future uses, which can be drastically compromised due to current development projects. The risks to that future can be addressed and mitigated when project developers are required to engage with indigenous people with an aim of achieving FPIC.

Dermot Foley, CFA, is Portfolio Manager – ESG Analysis at Vancity Investment Management Ltd. He takes a lead role in analyzing the environment, social and governance (ESG) risk of companies for the IA Clarington Inhance SRI Funds.

---

[1] Kinder Morgan Canada Limited's recent IPO was underwritten by a group of firms including TD Securities Inc., RBC Dominion Securities Inc., CIBC World Markets Inc. and Scotia Capital Inc. Each is an affiliate of a bank that is a current lender to Kinder Morgan or its affiliates and is expected to be a lender for a $4 billion credit facility.

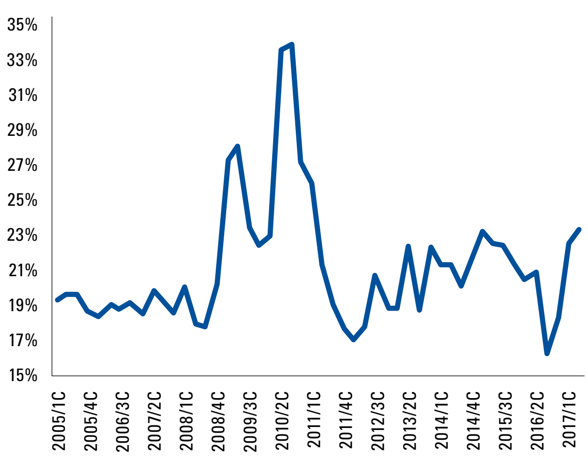
[2] "Honouring the Truth, Reconciling for the Future – Summary of the Final Report of the Truth and Reconciliation Commission of Canada", p. 137.

[3] Ibid., p. 306.

Economic and market commentary

In the midst of summer, thoughts often turn to holidays by the beach or the lake. Investors can be forgiven for spending a bit more time thinking about another summer tradition, the second quarter earnings season. The 2017 Q2 earnings have been of key interest to many given that equity markets continue to flirt with their highs. Are there any cracks to be seen in this expansion that has now tucked over eight years under its belt? At this time the answer remains steady-as-she-goes as investors continue to climb the wall of worry. Roughly 70% of the S&P 500 market capitalization has reported second quarter results thus far and they continue to be encouraging. The numbers have been ahead of general consensus with sales growing at mid-single digits and earnings growing at a very solid double digit pace. Profitability also paces at record highs as margins show continued expansion.

S&P 500 Incremental Operating Margins

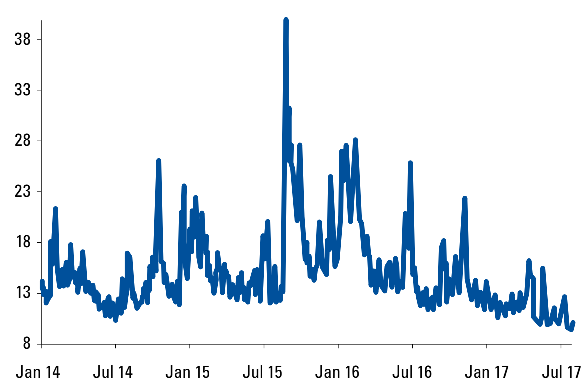


Source: Factset as of 2Q 2017 results to date; Based on 4Q sum of Y/Y change in EBIT and Sales.

A term that has been surfacing with increasing frequency when describing the current environment is "Goldilocks". The economy is not too hot, nor is it too cold but rather it is just right for a continuation of the secular bull market, with global growth breaking out from its 7-year range and inflation being behind the curve and still surprising downwards. Earnings growth in a benign inflationary environment has led to valuation multiple expansion. For example, the market price-to-earnings ratio (P/E) has seen the P grow faster than the E. This reflects an optimistic outlook where investors expect the positive result to continue. At current levels however, we don't expect returns to be on a straight line.

Despite solid equity market fundamentals, there are really two areas of concern in this market's wall of worry, extremely low market volatility and the U.S. Federal Reserve's (Fed) prospective balance sheet reduction. What is making some investors nervous is the low volatility in equity markets as identified by the U.S. VIX index, which shows implied equity market volatility is low relative to historical levels. For two weeks in July, the VIX closed below 10 every day – marking a period of the lowest volatility in the history of options trading (since 1983). Low volatility would not be a problem if not for strategies that increase leverage when volatility declines. Many of these strategies rely on selling into market weakness to cut losses, which can put upward pressure on volatility as stop-loss orders grow.

CBOE SPX Volatility Index (VIX)



Source: Bloomberg as of July 28, 2017.

Secondly, the Fed has announced its intentions to pare back its $4.5 trillion portfolio of fixed income assets. Although some expect stocks and other assets perceived as risky to come under further selling pressure amid the Fed's potential asset unwind, we believe that the pull back in July reflects some of this adjustment. Additionally, the Fed's policy intent has been transparently communicated to financial markets.

We believe solid global growth, strong corporate earnings and modest inflation have continued to support the equity market outlook for investors focused on maintaining their risk tolerance and long-term asset mix objectives.

Andrew Simpson, CFA, is the Portfolio Manager at Vancity Investment Management Ltd. He takes a lead role in the portfolio management of the IA Clarington Inhance SRI Funds.

We are iA Clarington.
And we will be invested in you.

As one of Canada's leading investment management companies, iA Clarington brings clarity, integrity and commitment to a complicated global investment landscape. We believe passionately in the value of active management, the investment products we deliver, and the importance of maintaining unwavering attention to both the big picture and the smallest details. Home to a number of highly respected portfolio management teams, together, we earn the trust of advisors and investors by bringing diverse investment views forward through our broad selection of offerings.

As a wholly owned subsidiary of Industrial Alliance Insurance and Financial Services Inc. – Canada's fourth-largest life and health insurance company – iA Clarington offers a wide range of investment products, including actively managed mutual funds, managed portfolio solutions and socially responsible investments.

Vancity Investment Management

iA Clarington™ Investments
be invested

522 University Avenue, Suite 700, Toronto, ON M5G 1Y7 | 888.860.9888 | funds@iaclarington.com | www.iaclarington.com

(17-0672) 07/31/17