ETHICAL + PASSIVE = Benefits for Your Institution and Your Investment Committee Members

Would you like to demonstrate to your stakeholders that your organization lives its values through investing? Would you like to easily implement your ethical investing policies? Would you like to lower investment fees? Would you like to reduce the burden on your investment committee? Would you like to have greater certainty in budgeting investment returns? Would you? Who wouldn't? This article highlights these five opportunities investors have when implementing a passive ethical strategy.

18 AM's Solution

18 Asset Management's passive ethical solution has client benefits firmly in mind. Our solution:

- Allows clients to demonstrate to their stakeholders that every effort is being made to live the values of the organization.
- Incurs investment management fees that are significantly less those of competing passive ethical products, eliminates custody costs and, importantly, reduces transaction costs to virtually nil.
- Utilizes a separate account enabling customization to each client's unique circumstances. Any index and any ethical prohibitions can be considered.
- Is easy to understand and explain to a client and their stakeholders.
- Uses **NO** derivatives nor leverage.
- Includes a reporting and customer service model geared to saving the investment committee's valuable time.
- Delivers passive returns in line with a client's applicable benchmark.

Ethical investing and passive investing are two current trends that are not only growing but gaining momentum. Ethical investing, which comes in many forms (from prohibited investments through to activism) and under many names and acronyms (eg. ESG and SRI), is becoming mainstream. The topic is garnering considerable media attention as various stakeholders are demanding action. For example:

- Students are protesting to have investment in certain companies or industries prohibited
- Donors want assurance that their donations are being managed in an ethical manner
- Employees want to know how their pension assets are managed
- The Governor General has issued a socially responsible investing challenge to community foundations across Canada

Clearly, the time is now for ethical investing. It is here to stay.

At the same time, there has been an explosion in passive investing. Exchange Traded Funds ("ETFs") abound, available for every conceivable index. The demand for ETFs is driven partly by their simplicity, partly by their low fees and partly by the failure of active management to show persistency in beating their benchmark after fees. US Equities is particularly prone to active management underperformance. There is a wealth of academic and practitioner research highlighting the propensity for active managers to underperform the S&P 500[1].

Interestingly, these two significant trends are converging. In certain asset classes, many institutional investors are looking to be passive and, at the same time, ethical. Here's what they have to gain and what they should consider:

1. Demonstrate to your stakeholders that you live your values through investing

Some institutions have ethical prohibitions in their investment policy statement yet waive those prohibitions if the investment committee decides to invest in a pooled fund or index fund. This exemption has generally been provided as it is believed solutions that are both passive and ethical do not exist. Yet, stakeholders know full well that exposure to the traditional index means exposure to undesirable companies.

Would you prefer to be able to demonstrate your commitment to ethical investing even when executing a passive approach?

2. Easily implement your ethical investing policies

ETFs and index funds represent an easy way to implement a passive and ethical allocation. However, before using these off-the-shelf solutions, investors should ask themselves the following:

- Does the fund's definition of ethical match your definition? Index products are built to appeal to as many investors as possible, often excluding investment in numerous companies and industries over and above what is prohibited in any given client's investment policy statement. Would you benefit from a solution tailored to the specifics of your investment policy statement?

- Does the index fund's required treatment of realized gains potentially impact you? The sizable redemption by even one long-standing fund investor can cause realized capital gains to be distributed to all investors in the fund. Would you prefer a separate account to avoid sharing in realized gain distributions of other fund unitholders?

- How quickly can money be redeemed from these investments? Many of the passive ethical funds have limited trading volume making it difficult and/or expensive to make the initial investment and subsequently redeem units. Would it be important to you to have an investment solution where your transactions can be done quickly, efficiently and with low cost?

3. Lower your fees

Passive investments carry much lower management fees versus active alternatives. Many ethical index ETFs exist but investors considering these options should be cognizant of the following:

- Investment management fees for passive ethical strategies are lower than typical active fees even if they are higher than standard passive options
- ETFs incur custody costs, a fee in addition to management fees
- Many ethical ETFs have very limited trading volume. Consequently, even small trades in these ETFs can incur sizable trading impact costs which can, in some cases, exceed the investment management fees

Would you benefit from transparency in and knowledge of all fees associated with your investment?

4. Reduce the performance monitoring burden on your investment committee

Take, as an example, a US Equity allocation, which is an integral component of a diversified, balanced portfolio. For actively managed US Equity allocations, the investment committee focuses considerable attention on monitoring the performance of their manager(s) against the applicable benchmark. By going passive in US Equity, this performance monitoring burden can be greatly reduced and resources can be shifted to other important considerations such as monitoring adherence to the investment policy statement and the prescribed asset mix.

Would you prefer to have your investment committee work on its most important responsibilities?

5. Have greater certainty in budgeting investment returns

A client's overall return is influenced by the return of the market and the extent to which the client's investment manager's return deviates from that market. For some investment styles, the amount of potential annual deviation from the market can be significant. No one can predict the market's return. However, by moving from active to passive management, the extent to which your returns deviate from the market return is reduced greatly, thereby reducing the range of potential outcomes.

Would you like to have greater certainty in budgeting investment returns?

If you answered "yes" to any of the above questions, we'd welcome hearing from you.

[1] SPIVA report June 30, 2016 http://ca.spindices.com/spiva/#/reports