Sustainable Investing Landscape for Canadian Fund Investors
Q1 2020

Morningstar Research Inc.
May 7, 2020

Ian Tam, CFA
Director of Investment Research, Canada
+1 416 484 7920
ian.tam@morningstar.com

Hidden Amidst the Noise

The coronavirus pandemic has certainly dominated both news headlines and investors' minds over the first quarter of 2020. But hidden amidst the news headlines is the fact that assets in sustainable funds among the retail marketplace continue to grow, with promising signs of performance during the pandemic and oil price war. The following paints a picture of the recent growth and trends within sustainable investments in Canada, inclusive of a summary of Morningstar's updated framework for identifying sustainable funds.

Key Takeaways

- In January 2020, Morningstar updated our intentionality framework for identifying sustainable investments in Canada. At present we've identified 105 such products available to the Canadian retail market.
- The majority of sustainable funds outperformed their peers over the deep drawdowns in the first quarter, providing an acute observation that investing sustainably does not necessarily come at the expense of returns.
- Although still a fraction of the total market, sustainable fund launches have increased over the past three years accompanied by a positive trend in asset flows to sustainable funds overall.

Morningstar's Identification Framework for Sustainable Investments

The area of sustainable investing has seen much attention over the last few years, capped off with an explosion of U.S. fund managers adding language around environmental, social, and governance to their prospectuses in 2019. With this increased interest comes ambiguity into what constitutes a sustainable investment, hence the need for a detailed taxonomy and framework for identification. To this end, on Jan. 31, 2020, Morningstar introduced a modified framework in identifying intentionally sustainable investments globally and has updated the Canadian funds database to reflect these new definitions. This intentionality framework is leveraged within Morningstar's fund research teams globally and specifies three scopes. The scopes are not meant as a measure of severity or amplitude, but rather to understand the type of sustainable attributes stated within the core mandate of a managed investment. To find this data, Morningstar looks directly to the prospectus of a fund, along with statements of additional information, and links to relevant marketing information if referenced directly in the prospectus.

Exhibit 1 Sustainable Investment Framework

Level 1		Sustainable Investment	
Level 2	ESG Fund	Impact Fund	Environmental Sector Fund
Level 3	ESG Incorporation	Gender & Diversity	Renewable Energy
	ESG Engagement	Low Carbon/Fossil-Fuel Free	Water-Focused
		Community Development	General Environmental Sector
		Environmental	
		Other Impact Themes	

Source: Morningstar Research Inc.

The above exhibit provides a breakdown of the three scopes.[1] ESG funds are those that use ESG risk factors as a central part of the investment process or are actively engaging with company management around the topics of ESG risk. Impact funds are those that seek to have a measurable impact along with financial returns around such topics as gender and diversity, low carbon/fossil fuel, community development, and other themes. Environmental sector funds are those that invest specifically in the green economy by investing in companies that will contribute to this cause, such as renewable energy, green transportation, environmental services, and climate resilience. This report will look at sustainable investments as a whole (Level 1 Scope). Detailed information on our sustainable fund attributes framework can be found within Morningstar Direct.™ At the end of the first quarter, Morningstar identified 105 sustainable investments domiciled in Canada under this updated framework.

1 Note that Morningstar Direct 3.x users will find these fields under the "Sustainability" view. The Level 1 scope will be labelled as "Sustainable Investment Overall," while the Level 2 scopes will be labelled as "Sustainable Investment – ESG Fund Overall," "Sustainable Investment – Impact Fund Overall," and "Sustainable Investment – Environmental Sector Fund Overall." These fields will appear as binary (Yes/No).

An Important Distinction

Although there are many funds and products that consider ESG factors into their investment process, this alone does not constitute ESG incorporation and subsequent inclusion in the sustainability framework. Although nuanced, the below fictitious examples of prospectus language serve to make the distinction between funds that consider ESG factors and those that have incorporated ESG factors.

ESG Consideration Language:
"As part of its fundamental analysis, the advisor evaluates a company's business environment, management quality, balance sheet, income statement, anticipated earnings, revenues and dividends, and other related measures or indicators of value, including certain environmental, social and/or governance (ESG) factors."

ESG Incorporation Language:
"The Fund's investments are subject to certain ESG criteria. The ESG criteria are implemented based on data provided by independent research vendor(s). All companies must meet or exceed minimum ESG performance standards to be eligible for inclusion in the Fund. The evaluation process favors companies with leadership in ESG performance relative to their peers."

The latter example stipulates concrete restrictions on companies that can be owned in the portfolio, whereas the former may point to ESG factors being secondary in the investment decision process and would not be deemed an ESG fund.

Morningstar Sustainability Rating™

Independent from the above taxonomy is the Morningstar Sustainability Rating (also known as the Globe Rating), which is intended as a measure of portfolio ESG risk relative to global category peers. Using individual company data from Sustainalytics, Morningstar rates the degree of ESG risk found within a fund by looking to the fund's holdings over the trailing 12 months and rolling up individual holdings' ESG risk ratings with emphasis placed on more recent holdings information. The Sustainalytics ESG risk rating measures the degree to which a company's economic value may be at risk driven by ESG issues. In order for a fund to receive a Morningstar Sustainability Rating, there must be ESG risk scores on at least two thirds (66.7%) of holdings. An investment does not have to be deemed sustainable under the identification framework for Morningstar to provide a Sustainability Rating.

Exhibit 2 Canadian-Domiciled Sustainable Investments

Morningstar® Sustainability Rating™	Number of Funds
🌐🌐🌐🌐🌐	27
🌐🌐🌐🌐	24
🌐🌐🌐	16
🌐🌐	4
🌐	0
Grand Total	71

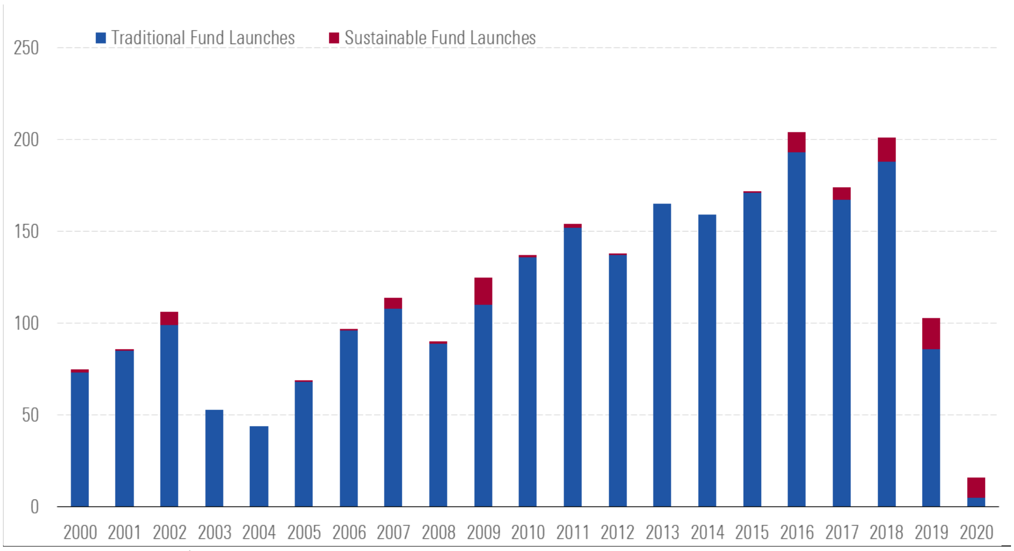
Source: Morningstar Direct | Ratings as of Feb. 29, 2020.

Though Morningstar's identification of sustainable investments is separate from the assessment of ESG risk, the above exhibit shows that the majority of funds identified as sustainable investments in Canada also tend to have lower levels of ESG risk, and hence higher globe ratings.

Product Launches

The size of the sustainable investment market is still small relative to the larger retail fund market in Canada, but it is clear that this is a growing area outlined by the number of new sustainable fund launches, in particular over the last three years.

Exhibit 3 Canadian Mutual Fund and ETF launches

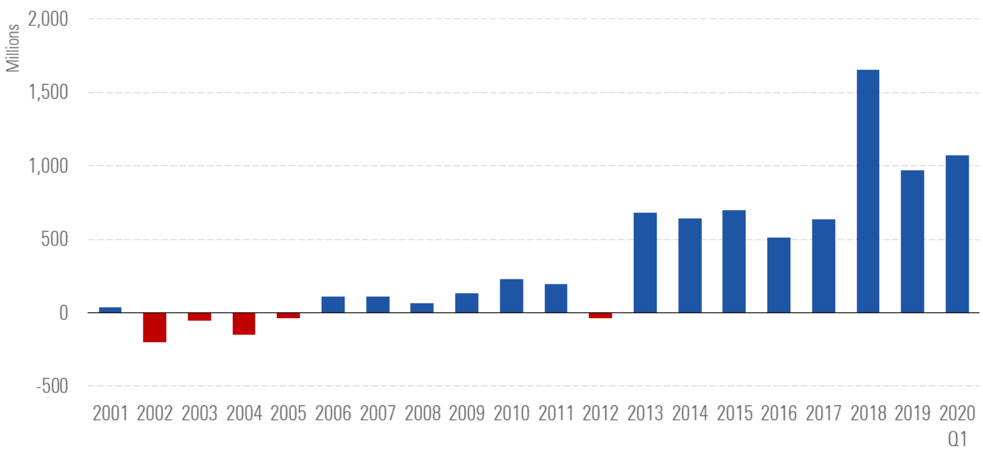


Source: Morningstar Direct | Data as of March 31, 2020.

The COVID-19 pandemic may have put a damper on new fund launches in the first quarter, but notably BMO pushed ahead with their launch of a new line of sustainable ETFs, which make up the majority of fund launches over the first quarter of the year. This pales in comparison with the number of sustainable funds in the U.S., but it is a trend that we hope to see continue in Canada as new products hit the market.

Asset Flows

Exhibit 4 Estimated Net Flows to Canadian Sustainable Investments (CAD, Millions)



Source: Morningstar Direct | Data as of March 31, 2020 | Excludes Fund of Funds.

Canada experienced positive but negligible net flows through the financial crisis and subsequent recovery. The steady growth into sustainable products started to acquiesce after 2013 with a large spike in inflows in calendar year 2018. The first quarter of 2020 had inflows into sustainable investments that outpaced the whole of 2019, which may point to more significant flows for the rest of 2020.

Market Share

True to form for the Canadian financial-services sector, the share of wallet for sustainable assets is dominated by a handful of large firms inclusive of NEI Investments, Desjardins, and RBC Global Asset Management, together making up 70% of sustainable investments in the Canadian retail market by assets, exclusive of fund of funds products.

Exhibit 5 Market Share of Canadian Sustainable Investments, Excluding Fund of Funds

Firm Name		Net Assets, Millions CAD	% of Market Share
NEI Investments	$	2,740	36.6%
RBC Global Asset Management Inc.	$	1,685	22.5%
Desjardins Investments Inc	$	915	12.2%
IA Clarington Investments Inc	$	467	6.2%
iShares	$	462	6.2%
Investors Group Inc	$	303	4.0%
AGF Investments Inc.	$	228	3.0%
BMO Asset Management Inc	$	152	2.0%
Mackenzie Financial Corporation	$	113	1.5%
All Others (Less than 1% Each)	$	417	5.6%
Total	**$**	**7,482**	**100%**

Source: Morningstar Direct | Data as of March 31, 2020 | Excludes Fund of Funds

For context, assets in sustainable investments as identified by Morningstar are still just a fraction of total assets in the mutual fund and ETF space (excluding fund of funds) in both Canadian and American markets.

Exhibit 6 Sustainable Investments Net Assets, Excludes Fund of Funds, Canada

Sustainable Investment Overall		Net Assets (Billions, CAD)	# of Investments Counted (all share classes)	As % of Total
No	$	1,276	15707	99.4%
Yes	$	7.5	331	0.6%
Total	$	1,284	16038	100%

Source: Morningstar Direct | Data as of March 31, 2020 | Excludes Fund of Funds.

Exhibit 7 Sustainable Investments Net Assets, Excludes Fund of Funds, U.S.

Sustainable Investment Overall		Net Assets (Billions, CAD)	# of Investments Counted (all share classes)	As % of Total Assets
No	$	24,647	22517	99.0%
Yes	$	250	1013	1.0%
Total	$	24,897	23530	100%

Source: Morningstar Direct | Data as of March 31, 2020 | Excludes Fund of Funds.

Clearly the assets invested in intentionally sustainable funds is small, with the U.S. showing a higher albeit negligible penetration rate compared with Canada. However, this does not necessarily mean that the consideration of ESG factors has not been on the rise. We continue to see a trend of fund companies adopting ESG techniques and considerations in their investment decisions. Language around these considerations has also been used widely in funds' prospectus documents and related filings. The universe of funds that consider ESG factors (but do not classify as sustainable investments) is much larger than the above. A more detailed look at the U.S. market landscape for sustainable investments is available here.

Relative Performance of Sustainable Investments Over Q1

The majority of intentionally sustainable funds outpacing peers over the first quarter of 2020, a time that tested the resolve of all managers.

Exhibit 8 Sustainable Investment Q1 2020 Category Ranks

	Top Quartile	2nd Quartile	3rd Quartile	4th Quartile	Total
Canadian Equity	1	4	4	3	12
Canadian Equity Balanced	1			1	2
Canadian Fixed Income	2	2	2		6
Canadian Fixed Income Balanced		1	2	1	4
Canadian Focused Equity		2			2
Canadian Neutral Balanced	2		1		3
Canadian Short Term Fixed Income	1				1
Canadian Small/Mid Cap Equity	1		1		2
Emerging Markets Equity	1	1	1		3
European Equity	1				1
Global Equity	8	15			23
Global Equity Balanced	3	2	1		6
Global Fixed Income			1		1
Global Infrastructure Equity			1		1
Global Neutral Balanced	1	2			3
Global Small/Mid Cap Equity	2				2
International Equity	2	2			4
North American Equity	1				1
Tactical Balanced				1	1
US Equity	3	2	2	1	8
Grand Total	30	33	16	7	86

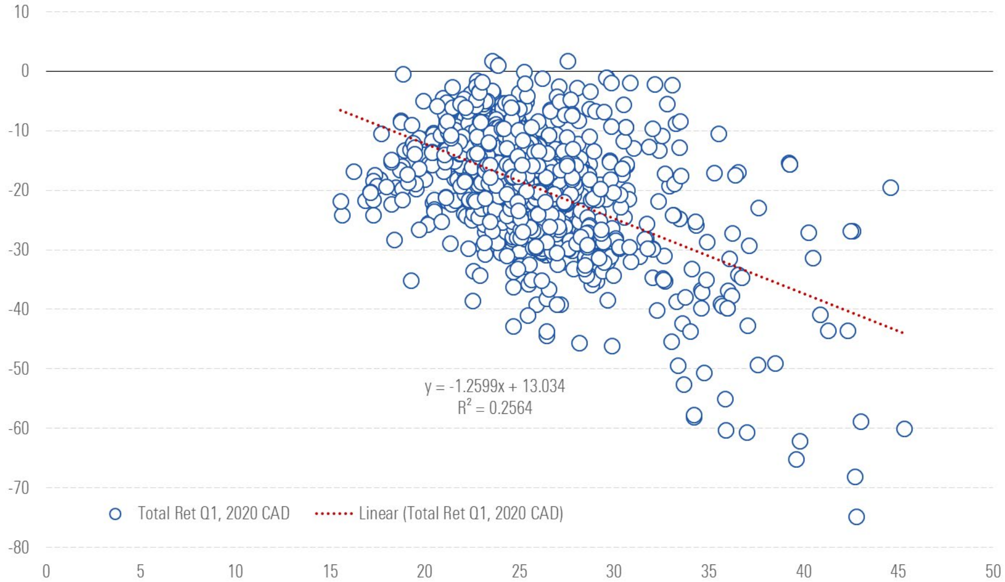
Source: Morningstar Direct | Data as of March 31, 2020.

Of the universe of ranked funds and ETFs domiciled in Canada, an overwhelming number (looking solely at the oldest share class of each fund) placed in the top half of peers within each Morningstar category. Recall that Morningstar's category ranks are calculated on a risk-adjusted basis, after fees. Of note are funds that manage to a global equity mandate in which all sustainable investments ranked in the top half. Managers with a Canadian equity mandate did not fare so well, with the majority of sustainable investments in domestic equities losing out to peers. On the whole, 73% of intentionally sustainable investments (63 of 86) placed in the top half of peers.

Morningstar Portfolio Sustainability Scores Over Q1

Separate from the fund's own prospectus, Morningstar assigns a portfolio sustainability score, derived from Sustainalytics' assessment of ESG risk within the portfolio regardless of intentionality. This is the underlying driver for Morningstar's Sustainability Rating.™ The following exhibit outlines said score as it appeared on Dec. 31, 2019, for all equity funds domiciled in Canada against total return over the first quarter of 2020. The score itself ranges from zero to 100, with scores over 40 representing high degrees of ESG risk. The lagged data for the score is intended to remove look-ahead bias.

Exhibit 9 Portfolio Sustainability Score vs. Q1 performance, Canadian-Domiciled Equity Funds



Source: Morningstar Direct | Sustainability Score as of Dec. 31, 2019, N=1892, Oldest Share Class Only.

Admittedly, a single quarter of performance will not provide a reasonable assessment of the explanatory power of the portfolio sustainability score. Nevertheless, a distribution of sustainability scores amongst equity managers in Canada can be seen above as well as an inverse relationship between performance (vertical axis) and the portfolio sustainability score (horizontal axis, lower is better). The simple linear-regression analysis shows a moderate significance over this time frame and universe of funds with an r-squared value of 0.26. This said, a more robust quantitative approach in analyzing the factor premium of ESG risk is available here for Morningstar Direct™ users.

Low-Carbon Funds in Canada

According to Natural Resources Canada, 10% of nominal GDP[2] stemmed from the energy sector in 2018. As such, a smooth transition to a carbon-free economy is of utmost concern for Canadians, as is the need for investors to be aware of their exposures to carbon risk, particularly for those who financially depend on the energy sector from the perspective of human capital versus financial capital.

Similar to the ESG risk score is the Morningstar® Portfolio Carbon Risk Score,™ also derived from Sustainalytics' research. A company's carbon risk score is tied to a firm's exposure to carbon-related risks throughout the value chain. It is Sustainalytics' view on the degree to which the firm's activities and products will be targeted for alignment with a low-carbon economy, and the quality of its management approach to reduce carbon risks. The score can range again from zero to 100 with values over 40 implying significant levels of carbon risk. At the portfolio level, aggregate scores less than 10 receive a low-carbon designation from Morningstar. Regardless of whether or not a fund company has declared the intention of being sustainable, a carbon-risk score is assigned to a fund if coverage of at least 67% of the underlying holdings is available.

Exhibit 10 Canadian-Domiciled Low-Carbon Funds' Category Ranks

	Top Quartile	2nd Quartile	3rd Quartile	4th Quartile	Total
US Equity	47	15	22	14	98
Global Equity	45	24	17	11	97
International Equity	31	8	8	7	54
European Equity	4	4	2	2	12
Asia Pacific Equity	3	3			6
Emerging Markets Equity	3	2	1		6
Global Equity Balanced	3	2		1	6
Canadian Focused Equity	4	1			5
Financial Services Equity	2		2		4
North American Equity	3		1		4
Asia Pacific ex-Japan Equity		2	1		3
Global Neutral Balanced	2		1		3
US Small/Mid Cap Equity	1	1	1		3
Global Corporate Fixed Income		2			2
Global Small/Mid Cap Equity		1			1
Greater China Equity				1	1
Grand Total	148	65	56	36	305

Source: Morningstar Direct | Low-Carbon Designation as of Dec. 31, 2019, Ranking Data as of April 21, 2020.

2 https://www.nrcan.gc.ca/science-data/data-analysis/energy-data-analysis/energy-facts/energy-and-economy/20062

Conclusions

Although still a small percentage of assets are invested in what Morningstar identifies as sustainable investments in Canada, the number of product launches and recent flows data tells us that there is certainly interest in this area. The COVID-19 pandemic that has caused deep drawdowns in investors' portfolios provided us a unique opportunity to observe the merits of having a sustainable approach. Although not nearly enough data is available to make a concerted conclusion, the above tables hope to continue to pique interest and can be interpreted as a commitment that Morningstar will continue to support and monitor this area of investing. M

Disclaimer
All care has been taken in preparing this report. However, please note we base our financial product research on current information provided to us by third parties (including financial product issuers) which we cannot necessarily verify. While we use all reasonable efforts to obtain information from reliable sources, we do not guarantee the data or content contained herein to be accurate, complete or timely. To the extent that our research is based on information received from other parties, no liability is accepted by Morningstar, its affiliates nor their content providers for errors contained in the report or omissions from the report. Morningstar determines its ratings on information disclosed to it by financial product issuers and on past performance of products. Past performance is no guarantee of future performance.

About Morningstar Research Inc. and Morningstar, Inc.
Morningstar Research Inc. is a Canadian subsidiary of Chicago-based Morningstar, Inc., a leading provider of independent investment research in North America, Europe, Australia, and Asia. The company offers an extensive line of products and services for individual investors, financial advisors, asset managers, retirement plan providers and sponsors, and institutional investors in the private capital markets. Morningstar provides data and research insights on a wide range of investment offerings, including managed investment products, publicly listed companies, private capital markets, and real-time global market data. Morningstar also offers investment management services through its investment advisory subsidiaries, with more than US$179 billion in assets under advisement and management as of March 31, 2020. The company has operations in 27 countries. For more information, visit www.morningstar.com/company. Follow Morningstar on Twitter @MorningstarCDN.

More Information
If you wish to obtain further information regarding this report, licensing and our services, please contact:

Morningstar Canada
1 Toronto Street, Suite 500
Toronto, Ontario M5C 2W4
Canada
+ 1 877 489 7074
www.morningstar.ca