Finance and the Environment in North America:

The state of play on the integration of environmental issues into financial research

Executive Summary

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Over the last few years we have seen dramatic evidence that international markets are recognizing both the risks and opportunities associated with how companies address and capitalize on the challenges of sustainability. The Carbon Disclosure Project, the Investor Network on Climate Risk in the U.S. and similar initiatives in Europe and Australia, collectively managing tens of trillions of dollars in assets, are pertinent examples of this trend. These and other investors are now calling on companies and securities regulators to provide enhanced disclosure about the financial risks that sustainability issues such as climate change pose to individual companies and what companies are doing to address those risks.

At the same time, North American companies that have demonstrated leadership by integrating sustainability principles into their business practices and strategies have suggested that the value, including the shareholder value, of their enhanced environmental practices and performance is not being recognized by the financial markets. Notwithstanding the proliferation of investor-led initiatives on sustainability issues, there is a concern that the mainstream investment community has, on the whole, simply not integrated environmental information into their investment analysis and decisions.

In order to develop a better understanding of the level to which mainstream investment professionals currently consider environmental issues as part of their valuations, a network of organizations, experts and practitioners from the finance, business, academic and non-governmental sectors, coordinated by Environment Canada and supported by the North American Commission for Environmental Cooperation (CEC), have developed the present project.

This report examines the current state of integration of environmental research into company and sector valuations by the mainstream financial community in Canada, the United States and Mexico. It aims to shed light on the drivers, tools, and understandings that lie behind the financial sector's incorporation, or lack thereof, of environmental factors into financial analysis and provides recommendations for facilitating the integration of these factors into the investment decision-making process. Through this effort, Environment Canada and the CEC hope to contribute to a growing body of research on the connection between environmental performance and financial value and to make this research more relevant to financial sector audiences.

Environment Canada and the CEC would like to thank the Network for its support and review of this report. We would also like to thank the authors, Matthew Kiernan and Sue McGeachie from Innovest Strategic Value Advisors, as well as Eric Kirzner from the University of Toronto Risk Management Institute for their commitment to this report and their nuanced analysis. Finally, we would like to thank the investment professionals who agreed to participate in this project and whose invaluable information and comments have contributed to making this report relevant and insightful.

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BACKGROUND

The purpose of this study is to determine the current state of integration of environmental research into company and sector valuations by the mainstream financial community in Canada, the United States, and Mexico. Among the key issues are: 1) to what extent does the mainstream financial community currently incorporate environmental sustainability information into stock assessments; 2) to the extent that they do, how this is done; 3) to the extent that they do not, what are the principal barriers; and 4) possible measures to address these barriers.

The attitudes, perceptions, and behaviour of the investment community have an enormous impact on corporate executives and boards of directors. Any factor that affects investors' assessments of companies will also become a central concern for the leaders of the company. Companies are facing increasing pressure from their stakeholders, including investors, to address their environmental performance impacts and improve disclosure on the potential financial risks and opportunities associated with environmental issues. This report represents one of the first systematic efforts to understand if and how mainstream investors are thinking about and integrating environmental issues into their decision-making processes and the reasons behind this.

This report is part of the first stage of a critically important dialogue among three key groups with substantial capacity to consider the integration of environmental factors into the investment process: institutional investors, asset managers and consultants, and government. It is a dialogue that is increasingly conspicuous by its absence in all three North American countries.

Research for this project began with the identification of key environmental issues that have a high likelihood of financial impact on corporations. The four issues selected for detailed examination were climate change, air quality, water usage/pollution, and contaminated land. The sectors most affected by these issues were judged to be oil and gas, chemicals, utilities, and mining.

The primary research goal was to determine the extent to which these environmental issues impacted the stock valuation/selection process for each of three key groups of investment professionals: 1) financial analysts; 2) portfolio managers; and 3) investment consultants.

> “The currently dominant interpretation of fiduciary responsibility is relatively narrow and generally views consideration of environmental issues as at best a distraction and at worst injurious to investment returns.

How each of these three groups of investment professionals views environmental considerations impacts the other two. The analysts attempt to value a firm in financial terms, paying specific attention to factors that could impact a company's bottom line. Portfolio managers use the analysts' research to make stock selections and so drive much of what an analyst will focus on. Investment consultants are hired by the investment clients to help determine a policy for their investment structures and set a mandate for, as well as select, investment managers. Portfolio managers are largely constrained in their stock selections by their clients' investment mandate. Investment consultants are highly influential, both in helping design mandates and in choosing managers to run them.

PERSPECTIVES OF INVESTMENT PROFESSIONALS

Limitations of the Study

It immediately became clear that environmental issues are not yet on the radar screen in any significant way among investment professionals, as was demonstrated by the relatively small number of professionals willing to be interviewed on the subject. The results of this study, therefore, must be interpreted with some caution. Ultimately, only 41 interviews were undertaken, despite repeated and persistent efforts to increase that number substantially. The study's authors believe that there were several reasons for the muted response and that the response level is in itself an important finding of the study.

Perhaps the chief reason for the limited response was the prevailing belief among investment professionals that environmental concerns are not especially material to stock valuations. This was particularly the case in Mexico, although this challenge was prevalent, albeit to a lesser extent, in Canada and the United States as well. There were a number of reasons for this. Firstly, analysts for the most part felt that an environmental issue that may have been relevant in a stock decline would have been only one cause among many of this eventual stock downturn. Investment professionals appeared to feel that these causes, or overall management-related risks, could be captured using their traditional valuation methods.

Secondly, the currently dominant interpretation of fiduciary responsibility is relatively narrow and generally views consideration of environmental issues as at best a distraction and at worst injurious to investment returns. Pension plan sponsors are, therefore, generally wary of what they believe to be potential adverse legal ramifications should they later be judged to have abrogated their fiduciary responsibilities by addressing “non-financial” factors.[1]

Finally, environmental issues were considered a long-term problem and therefore not relevant to investment professionals, whose performance is almost invariably measured by looking at quarterly returns. The sections below examine in more detail the extent to which environmental issues are integrated in the investment process by each of the three key groups of investment professionals.

Financial Analysts

Interviews with financial analysts established that environmental issues were considered, to varying degrees, in the analysts’ company performance predictions and sector outlooks, although “considered” often meant simply a brief qualitative discussion of the issues and their potential impact on the sector. The main consensus among the analysts interviewed was that environmental information could not be properly quantified.[2] Reasons for this are highlighted below:

- ***Long-term Versus Short-term:*** Environmental issues are usually long-term, whereas analysts generally take a short-term view. According to the analysts, they have enough time to change a stock rating once there is a concrete reason to do so.

- ***Legislative and Regulatory Uncertainty:*** Analysts felt that they could not provide a precise discounting or valuation on environmental issues because of constantly changing rules (e.g. changing regulations or uncertainty surrounding scientific evidence).[3] This has possibly led to the fact that North American analysts generally do not perform scenario analysis on how different legislative changes might affect their stocks to the extent that British and European analysts do.

[1] In 2005, international law firm Freshfields Bruckhaus Deringer addressed the legal framework for integrating environmental and other non-traditional analysis in the investment process. The firm’s results were produced by the United Nations Finance Initiative in a report entitled *A Legal Framework for the Integration of Environmental, Social, and Governance Issues into Institutional Investment*, October, 2005.

[2] Bauer et al. tackled this subject in a study that resulted in an article for the Financial Analysts Journal, Volume 61, Number 2, 2005, entitled *The Eco-Efficiency Premium Puzzle*.

[3] Analysts do value other qualitative factors, such as management quality, corporate governance, market conditions for new products or services, and employee relations. These examples suggest that valuation tools exist to integrate the more qualitative factors (at least on a speculative basis), but these tools are, for the most part, not being used to assess environmental concerns.

Another possible reason for this discrepancy, according to one Canadian utilities analyst, is that Canadian legislation has traditionally had little teeth — i.e. minimal impact on firms — at least in that industry sector.

• ***Questionable Relevancy of Sustainability Reports:*** Company reports on environmental performance appear to be largely irrelevant to analysts. Such reports, they felt, were of limited value without an independent expert's opinion on these issues. The analysts said that they themselves do not have enough background information on what the companies are tracking and reporting with respect to their environmental performance to determine their financial relevance.

• ***Availability of Other Proxy Indicators for Strong Environmental Performance:*** The research suggests that analysts feel that environmental performance is already reflected in other indicators — for example, good management or changes in cash flows. Companies may not perform well environmentally due to cash or financial problems, and this, the analysts felt, can be assessed using traditional valuation methods. If a company's finances are sound, it is more likely to have good environmental management systems in place. If the company is struggling financially, environmental systems are one of the more likely programs to be down-scaled in favour of cost savings.

• ***Regulatory and Compliance Mindset:*** The overwhelming majority of analysts interviewed saw environmental factors as regulatory and compliance matters, rather than as potential sources of competitive advantage or risk.

> "The main consensus among the analysts interviewed was that environmental information could not be properly quantified.

> "The overwhelming majority of analysts interviewed saw environmental factors as regulatory and compliance matters, rather than as potential sources of competitive advantage or risk.

Portfolio Managers

The most common strategy for portfolio managers is one that utilizes an ad hoc approach to considering environmental issues, as opposed to something that is routinely measured in a stock selection framework (although exceptions were noted). Environmental performance alone, therefore, tends not to be a discrete factor in stock selection or in divestment decisions should the manager be dissatisfied with the stock performance. Environmental issues may, however, be addressed in the following indicators that managers monitor:

- ***Legal Issues:*** Managers will generally avoid firms if there are many legal issues, including environmental ones.

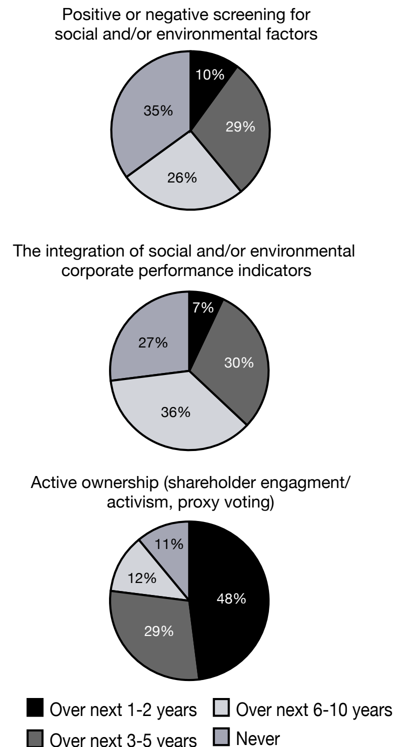
- ***Predictions of Cash Flow:*** Environmental issues may occasionally factor into predictions of cash flow, usually in the form of risks to cash flow. As was previously noted, managers do not generally focus on opportunity factors associated with environmental issues unless these are directly traceable to cash flow.

There was found to be a regional bias regarding environmental integration in mainstream investing practices. According to Mercer's 2005 Fearless Forecast survey of investment managers worldwide, managers' responses to whether certain socially responsible investing (SRI) practices (the act of including environmental and social considerations in mainstream investments) would become a common component of mainstream investment processes in the near and long term varied according to region, with U.S. managers being the least convinced and Asian and Australian managers being the most convinced.

The Mercer survey found that managers, on the whole, are becoming convinced that social and environmental issues will become part of mainstream investment strategies and practices, in some form or another, as demonstrated in Figure 1.

Mercer concludes that managers overall do expect social and environmental issues to become relevant in the mainstream investment decision-making process and states that its own manager research will now include a consideration of how investment managers account for these issues in their mainstream strategies.

Figure 1: Practices Relating to Social and Environmental Issues Predicted To Go Mainstream



Source: 2005 Fearless Forecast, ©2005 Mercer Human Resource Consulting LLC and Mercer Investment Consulting, Inc.,

Investment Consultants

The investment consultants interviewed all stated that environmental concerns are generally not addressed within the investment mandates of their institutional investors. It was noted that, in *some* cases, there was the possible exception of specific screening requirements, although it is rare for these to be included in the investment mandate, according to the consultants. Investment mandates did not include any type of "non-traditional" analysis unless specifically stated. This was the case even for clients such as church groups, traditionally a sector with strong ties to SRI. This may be due to the fact that, because the investment mandate is so rigorously monitored and the investment manager's performance and compensation are so directly linked to it, mandate stipulations must be as clearly defined and followed as possible. The investment consultants tended to feel that most people were still feeling their way with regard to environmental risks and opportunities, which made it difficult to include environmentally related criteria in something as concrete as the investment mandate.

"Consultants still remain, for the most part, extremely cautious about integrating environmental risks/opportunities in the investment process.

Overall, it appears that consultants remain, for the most part, extremely cautious about integrating environmental risks/opportunities in the investment process. There was, as well, little knowledge or understanding about the variety of methods for incorporating environmental analysis into the stock selection process and the differences among such methods — i.e. that some are more rigorous, sophisticated, and helpful than others. Like many other members of the investment community, consultants tend to equate sustainability investing automatically with exclusionary, negative screening. This then raises legitimate concerns about portfolio diversification, risk, reduced returns, and therefore fiduciary duty. Finally, the research suggests that the compensation structure does not yet encourage the integration of long-term issues such as environmental issues into investment mandates, although there is evidence that this is slowly beginning to change.

Generally, consultants felt that mainstream investors are unlikely to become proactive in including environmental factors in investment decisions until one of two things happens:

1. It becomes clear that incorporating these factors will generate a better return (or effectively mitigate risk).

2. The investment community is forced to consider these factors through legislation.

It was noted, however, that several trends emerging in the consulting arena could influence the consideration of environmental issues in the near term.[4] These are highlighted below:

- ***Relatively Recent Focus on Longer-term Mandates:*** Perhaps the most important trend is the relatively recent tendency to consider longer-term mandates for managers, in an effort to alleviate some of the problems that accompany short-term (e.g. quarterly) monitoring and measuring of managers' performance.

- ***Pressure to Increase the Range of Investment Options:*** There is apparently some recent pressure from plan members for plan sponsors/trustees to increase the range of options available to members in terms of both risk/return characteristics (e.g. hedge funds) and what are still considered to be "softer" issues, including environmental concerns.

- ***Increasing Relevance of "Extra-financial" Issues:*** "Extra-financial" issues are becoming more relevant in the pension environment because: 1) more investment beneficiaries are asking for further clarification around these issues; 2) disclosure requirements are being tightened; and 3) some British and European managers are acknowledging that they may have been missing social/environmental-related risks in these discussions.

GEOGRAPHICAL PERSPECTIVES ON ENVIRONMENTAL ISSUES

The secondary goal of this report was to compare the extent to which the investment community integrated environmental factors into their decision-making processes among countries in North America and between North America and the rest of the world (mainly Europe and the United Kingdom).

North America

Canada currently appears to lag behind the United States when it comes to the integration of environmental issues into stock considerations. A major reason for this could be the relatively recent push from U.S. institutional clients, such as CalPERS, CalSTRS, and the State of Vermont, for the integration of environmental considerations into the investment process. There is as yet no such evidence of such initiatives in Canada.

[4] In October 2005, Mercer Investment Consulting released a report in the UK, in collaboration with the UK-based Institutional Investors Group on Climate Change and the Carbon Trust entitled *A Climate for Change: A trustee's guide to understanding and addressing climate risk.*

The primary concern in Canada and the United States with addressing environmental issues is that, for many in the investment community, integrating environmental issues into stock considerations is tantamount to screening “out” companies or even entire industry sectors, which mainstream investment professionals are particularly reluctant to do. Specific mandates and investment constraints already limit available investment opportunities for many investment managers, especially pension funds, mutual funds, and other institutional managers. This may change in Canada, however, with the recent elimination of the foreign property limitations in Canadian investments.

The research found the investment community in the United States to be somewhat more open to the idea of incorporating environmental criteria into investment strategies, but only as part of an SRI niche, as opposed to its broader application in regular stock selections and valuations. One factor in raising awareness of social and environmental issues in the United States, however, is the increased emphasis on improving the tracking and transparency of corporate information so that there are fewer surprises — including, but not limited to, environmental risks — for investors. This effort has found its most concrete expression in the Sarbanes-Oxley Act in the United States, although the connection with environmental disclosure is only tangential. Additionally, the federal Government Accountability Office produced a major report stating that the Securities and Exchange Commission should explore ways to improve the tracking and transparency of information. This report addresses key stakeholders’ views on how well the Securities and Exchange Commission has defined the requirements for environmental disclosure, as well as experts’ suggestions for increasing and improving environmental disclosure.[5]

Investment professionals in Mexico stated that the environment has no impact on stock valuations in their country. They did cite examples of environmentally related reputational damage to firms, but these, according to the interviewees, did not have enough of an impact on stocks to make it worth their time to address these issues systematically or proactively.

[5] United States Government Accountability Office Report to Congressional Requesters, *Environmental Disclosure: SEC Should Explore Ways to Improve Tracking and Transparency of Information*, July 2004.

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The presence of explicit legislation appears to be a primary driver for the preponderant interest in environmental issues — or at least an acceptance of a longer-term view in measuring investment performance — in the investment communities in the United Kingdom and Europe compared with North America.

North America In A Global Context

When assessing how environmental issues are integrated into stock considerations, it is first useful to consider the global context. The research suggests that environmental issues, as they relate to investment decisions, are considered much more seriously and systematically in the United Kingdom and Europe than in North America, and more in the United States than in Canada.

Professionals in the United Kingdom, for example, are generally more willing to address the issue and overall have a better appreciation of its potential relevance to their work. There is a general consensus in the United Kingdom investment community that, while environmental concerns may fade slightly with downturns in the market, they will not disappear altogether due to their growing importance in the public policy arena. The same sentiment did not appear to be echoed in Canada and the United States, with Canadian investors actually falling behind their U.S. counterparts.

Reasons for this discrepancy appear to be threefold. The first is lack of legislative support in North America to the same extent that exists in Europe and the United Kingdom. The second is an overall lack of investment interest in such issues from the private sector side in North America. Both policy-makers and institutional investors in the United Kingdom and Europe have driven the demand for greater disclosure on corporate long-term performance, including environmental performance. The third factor may be cultural: there is, quite simply, a stronger overall ethos of environmental awareness and concern in the United Kingdom and Europe. This may, in turn, be due to the generally greater population densities and relative absence of unspoiled environmental resources.

Recognizing this gap between Europe and North America with regard to incorporating long-term or extra-financial issues in the investment process, a 2003 United Nations Environment Programme report encouraged North Americans to emulate their European counterparts with the following recommendation: "Policy makers and investors may be the most effective catalysts for North American research firms to incorporate social, environmental and corporate governance indicators into their work." [6]

The presence of explicit legislation appears to be a primary driver for the preponderant interest in environmental issues — or at least an acceptance of a longer-term

[6] United Nations Environment Programme Finance Initiative, *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing,* Geneva, 2004.

view in measuring investment performance — in the investment communities in the United Kingdom and Europe compared with North America. This has resulted in increased activity among mainstream asset management firms in the United Kingdom and Europe, many of which are building large internal research and "engagement" teams in an attempt to capture proactively the environmental risks and opportunities associated with their investments.

> "As long as investors do not know how to properly value an environmental opportunity, risk, or liability, they will continue to dismiss such extra-financial information.

Legislation in the United Kingdom and Europe has introduced the notion that environmental factors may be important to stock valuations and selections by obligating pension funds and their money managers to at least consider the possibility explicitly. While the investment community may still be unsure of how to incorporate this additional information and may indeed still be facing the same cognitive barriers as their North American colleagues, the fact that legislation stipulates that these issues may be important lends credence to the fact that integrating environmental issues in stock consideration processes is, in fact, possible, and even desirable. Australia goes even further, in that any fund purporting to offer a product that takes into consideration social and/or environmental issues must state specifically the methodology behind this. Canada has made some legislative changes as well, most notably changes to the National Instrument 81-106 Investment Fund Continuous Disclosure, which include proxy voting disclosure requirements for securities. Such changes, however, do not appear to have had the impact of those mentioned above in the United Kingdom and Europe.

A 2005 report by the World Economic Forum and AccountAbility[7] also supports the above view that the absence of disclosure regulations can impede the integration of environmental (and social) issues into mainstream investment considerations. The report uses the example of the U.S. Securities and Exchange Commission's failure, first, to require companies to disclose material environmental liabilities and, second, to redefine what is and should be material for investors. The report goes on to point out that as long as investors do not know how to properly value an environmental opportunity, risk, or liability, they will continue to dismiss such extra-financial information.

[7] World Economic Forum & AccountAbility, *Mainstreaming Responsible Investment*. Janvier 2005..

CONCLUSIONS

The most important conclusions emerging from the research were the following:

1. The level of actual integration of environmental factors into mainstream financial analysis in North America is both relatively low and almost entirely ad hoc.

2. Despite this, there is a significant level of *awareness* of environmental issues; what is missing are both the motivation and tools for *translating* that awareness into concrete investment decisions and strategies.

3. There are a number of powerful reasons for this gap between awareness and action, possibly the most important of which is the widespread belief that integrating environmental considerations is incompatible with optimal financial performance, and therefore with fiduciary responsibility. Other reasons include:

i. The considerable tension between the long-term nature/impact of environmental issues and the short-term time horizons on which investment professionals are typically evaluated and compensated.
ii. A pervasive skepticism about the financial and competitive relevance of environmental factors.
iii. The resulting lack of demand for environmental research from institutional investor clients.
iv. The general lack of "fit" between the type of environmental information provided by companies and that which would be useful for investment professionals.
v. The lack of analytical tools with which mainstream analysts could integrate environmental information, even if that information were provided in a useful format.

4. Until institutional investor *clients* begin demanding of their money managers the integration of environmental factors, it is highly unlikely that the other key actors in the mainstream investment world will pursue it spontaneously.

5. Pension fund trustees are effectively the decision-making proxies for the institutional clients. Until the depth and extent of their awareness of environmental issues and their comfort with including environmental factors increase significantly, client demand is unlikely to materialize on a wide scale.

RECOMMENDATIONS

The recommendations in this report are directed primarily at public policy-makers, with the aim of facilitating the integration of environmental factors into the investment decision-making process. These recommendations are focused on improving the "framework conditions" that determine which changes are and are not possible within the investment value chain. In the absence of material improvements in the framework conditions, it is highly unlikely that change will occur spontaneously among the key actors in the institutional investment process.

Government, however, can only do so much to encourage investors to recognize the inherent long-term environmental risks and opportunities in their investment practices. Investors themselves and the companies they own must also play a role; therefore, this report directs recommendations to these key constituents as well.

The recommendations below are structured to address the barriers to integrating environmental considerations into investment practices and how each of the three key constituents can begin to overcome these.

A. Government

1. Draft legislation requiring institutional investors, mutual funds, and foundations/ endowments to disclose publicly how they consider environmental issues in their investment practices.[8]

The research found that one of the most basic barriers to integrating environmental considerations into investment practices in North America was the absence of legislation or regulation requiring institutional investors to address such issues, such as exists in Europe, the United Kingdom, and Australia. Even if institutional investors choose to state publicly that they do not consider environmental issues, at a minimum, requiring them to disclose this puts the issues on the investment agenda. While the research did find that such legislation does not necessarily result in the uptake of environmental considerations in investment decisions, it does result in creating the *perception* within the investment community that such integration *is* in fact feasible, which goes a long way towards setting the stage for discussion around these issues.

[8] The first and second recommendations under "Government" have also emerged as the principal recommendations in a report prepared for the National Round Table on the Environment and the Economy on pension fund disclosure (see Wheeler, David et al., *Comparative Study of U.K. and Canadian Pension Fund Transparency Practices*, National Round Table on the Environment and the Economy, 2004). Following extensive national consultation (now largely completed), these will emerge early in 2006 as principal recommendations of the Task Force on Capital Markets & Sustainability. The recommendations will appear as part of a "State of the Debate" report, which will include an extensive discussion and analysis of current trends and issues as well as specific recommendations to government.

A good beginning would be to have government require disclosure from public pension funds, such as the Canada Pension Plan Investment Board (CPPIB). The government could, for example, encourage other institutional investors by ensuring that the CPPIB includes an explicit policy on "environmental investing" in the plan's formal statement of investment principles. The CPPIB's independent decision to adopt its new Policy on Responsible Investment, a policy that explicitly commits to further research and engagement with companies on environmental, social and governance issues, is likely to draw attention to the issue in the Canadian investment community.

2. Redefine the notion of fiduciary duty to allow for considerations of the so-called "softer" issues.[9]

Legislation similar to that in the United Kingdom, Europe, and Australia would provide trustees and other fiduciaries with the reassurance that they *could* in fact consider environmental factors without jeopardizing their fiduciary responsibilities, provided that traditional financial factors also receive due emphasis.

3. Align fiscal and regulatory signals with the real cost of environmental impacts.

Even in the absence of such legislation as described above, it was found that investors *would* indeed consider environmental issues (and do where they are material) *if* they felt that such issues had a measurable impact on companies' bottom lines.

According to the research, however, investors did not feel that such issues, for the most part, were material under the current political and regulatory framework in North America. In the current framework, only a subset of a company's environmental impacts affects its financial performance directly. Some examples of how the government might address this are as follows:

> *i.* Conduct a cost assessment to determine the extent to which environmentally related costs are directly related to corporate activities, and price these activities more appropriately through taxation, fines, and incentives. The most obvious example is the increasingly prevalent link between air quality and health care issues.

[9] Ibid.

ii. Align fiscal policy with clear, robust environmental signals throughout the production and consumption value chains through taxation and other market-based instruments.

iii. Create a compliance and enforcement regime that results in material financial risks/opportunities for companies.

iv. Make greater use of market-based instruments, such as a carbon emissions trading system.

4. Work with local securities regulators to ensure that company reporting and disclosure requirements adequately reflect the growing importance of environmental factors in companies' financial performance.

It was found as well that disclosure requirements that should allow investors to recognize environmental risks do exist, but these are not properly enforced. Efforts on the part of regulators to enforce such disclosure requirements should be increased. Enforcement, therefore, must be seen to be as important as legislation.

5. Implement a comprehensive education and engagement initiative.

Recommendations 1–4, which create a framework for the business case for investors to address environmental issues in investment practices, should be implemented in tandem with a comprehensive education and engagement initiative to facilitate the proper integration of such issues. Education and engagement tools include the following:

i. Convene a forum where investors, policy-makers, and corporate leaders could meet to share views and insights on the materiality of environmental finance.

ii. Create educational modules to increase the level of trustee education and training on "fiduciary responsibility," the link between environmental performance and profitability, and how to address environmental considerations in investment strategies.

iii. Convene a forum with chartered financial accountants, environmental specialists, investment analysts, and possibly regulators to begin an initiative on processing prospective environmental issues such as climate change and translating this into the effect it can have on a company's financial position. The end goal is to develop documented guidance on how companies and auditors can interpret environmental information — for example, greenhouse gas emissions — and translate this information into the financial statements in a way that is relevant to the investment community. From this, training programs for auditors on the materiality of environmental issues can be created.

iv. Create training modules for auditors. These could focus on at least raising awareness regarding environmental data in corporate sustainability reports and ensuring that such data, where appropriate, are disclosed in the company's Management Discussion & Analysis (MD&A).

6. Support and/or conduct additional research to address the remaining gaps in knowledge relating to environmental finance.

Further study into certain key areas would greatly facilitate education and engagement efforts with the private sector. Areas in which additional research would be useful include:

i. The link between environmental and financial performance. To date, there has been very little empirical research examining the financial impacts of environmental performance on Canadian firms. Such research has been conducted in other countries and has begun to have a discernible impact on mainstream investment thinking and practice.[10] This research would be most effective if it combines the insights of academics, specialist research houses, and investment practitioners.

ii. A study examining precisely what company information would be most useful to investors and how it could most usefully be presented.

[10] See, for example, Derwall, Jeroen et al., The Eco-Efficiency Premium Puzzle, *Financial Analysts Journal,* 61(2) (2005), and Gluck, K. & Becker, Y., Can Environmental Factors Improve Stock Selection, *Journal of Asset Management* t5(4):220–222 (2005).

iii. Sector-specific studies that identify the environmental risks and opportunities in each sector and specify what information companies in those sectors should be disclosing to properly account for these risks to investors and other stakeholders.

iv. A feasibility study on developing and integrating environmental finance modules in investment professionals' training.

B. Corporate Management and Directors

7. Management ought to ensure that environmental information addresses all material risks (and opportunities) in a way that is relevant and useful to the financial sector.

The research found that there is currently a disconnect between the environmental information reported by companies and the information that investors consider relevant or useful. This prevents even those investors who are inclined to integrate environmental factors into their analysis from doing so.

Those companies that are environmental leaders are, therefore, not seeing their efforts rewarded in their stock price, and this is a significant missed opportunity. It is, then, in their best interests to work with the investment community to devise a system of environmental disclosure that accurately reflects corporate activities. If environmental leaders take this initiative, it would force the laggards to disclose the same information, thereby allowing investors to accurately assess all material risks in a timely manner. The study mentioned above (Section A, 6 ii) could provide a valuable platform to support this work on a wide-spread basis.

8. Corporate directors ought to be aware of all environmental risks and opportunities facing the company and sector and ensure that management is addressing such risks/opportunities, as well as accurately disclosing these to investors. They should also have access to the education that would be required for them to effectively fulfil their obligations.

Under recent changes to regulations, corporate directors in Canada have to approve all corporate disclosures by signing off on the financial statements and the MD&A. It would befit them, therefore, to learn as much as possible about all environmental risks and opportunities that may have a material impact on the company, as well as how these should be disclosed to investors. Environmental risks should be disclosed in both the financial statements and the MD&A. The National Round Table on the Environment and the Economy has produced a major paper on MD&A disclosure that provides an analysis of these issues.[11]

Educational programs that target directors should acknowledge the environmental risks that companies face that can have a material impact on financial performance. In Canada, these include programs delivered by the Corporate Governance College, run jointly by the Institute of Corporate Directors and Rotman School of Business, and the Directors College, a promising joint venture between the Conference Board of Canada and the De Groote School of Business at McMaster University.

C. Investors

9. Address the "SRI overhang."

The research found that most analysts, portfolio managers, and consultants in North America do not distinguish between addressing environmental risks/opportunities on the one hand and SRI on the other. This places the North American investment community behind investors elsewhere in the world, who are more open to including environmental information that is financially relevant. In North America, even when purely financial arguments are made for including environmental information, these tend to be lost or overwhelmed by a general skepticism about the relevance of such inclusion. This presents a missed opportunity for generating additional financial performance.

10. Look abroad for best practice tools for integrating environmental considerations into investment practices.

Following Recommendation 9 above, the "SRI overhang" prevents the North American investment community from using a number of tools used elsewhere in the world that allow them to address environmental issues systematically, with minimal impact on their current

[11] See Financial Reporting Disclosures about Social, Environmental and Ethical (SEE) Issues, prepared by the Canadian Institute of Chartered Accountants for the National Round Table on the Environment and the Economy, November 2004.

investment practices. Such tools include:

i. Incorporating environmental ratings in analytical models from independent environmental research firms. This will at least flag underperformers so that investors can be aware of the existing risks.

ii. Using independent environmental reports on stocks as points on which to engage corporate directors regarding environmental risks.

iii. Ensuring that investment staff acquire a reasonable level of understanding around the potential for environmental issues to impact financial risk and return and the available implementation options for clients to address this.

11. Review the work from investment consultants regarding longer-term investment mandates.

Reports from leading investment consultants, including Watson Wyatt,[12] have identified the value of awarding investment mandates where the principal investment objectives are defined and measured on a long-term basis, even as much as 10 years. As environmental issues are typically long-term concerns, prudent managers with long-term mandates should consider the inherent risks and opportunities such issues present.

12. Use the current trend towards engagement as an advantage by addressing environmental issues that pose long-term risk with corporate executives.

Watson Wyatt's Global Investment Review[13] notes that Canada's pension funds have recently become more activist, showing a much greater interest in voting proxies and engaging with company management. In the United States, according to the same review, there is a defined contribution–style transfer of investment risk from the government and plan sponsors to individuals. As individuals become more engaged in their investments, they may also become progressively more interested in the inherent risks and opportunities, including those presented by environmental issues.

[12] Watson Wyatt, Short-termism — A Real or Imaginary Problem, in *Remapping our Investment World*, 2004. Available at: http://www.watson-wyatt.com/asia-pacific/australia/news/docs/RemappingAus.pdf.

[13] Watson Wyatt, Global Investment Review 2005. Available at: http://www.watsonwyatt.com/europe/pubs/globalinvestment/.

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