

## Appendix B - Ethical Investing

The past decade has seen a dramatic increase in the number of institutions and individuals who wish to align their moral values with their investment activities. The main difficulty which investors face in implementing an ethical (socially responsible) investment strategy is in the setting of their ethical investment criteria and knowing how the ethical constraints will impact their portfolio performance.

The ethical investor seeks to strike a balance between investment restrictions and their fiduciary duty<sup>1,2</sup>. As a fiduciary, the investor must ensure that any investment must be made for the benefit of participants. In some cases, when setting ethical constraints, that guideline is clear. A hospital foundation having a restriction against investing in tobacco stocks would not be an issue, since some of the beneficiaries of the foundation's investment would be engaged in fighting cancer and heart disease - the results of tobacco use. Other circumstances are not as clear, such as investing in a company with mines in Cuba. While a case could be made that mining damages the environment and firms doing business with Cuba could be seen as supporting a totalitarian regime, counter arguments would be the mine helped Cubans earn a living and the investor's duty is to all fund beneficiaries, some of whom would support a Cuban mine.

In constructing a decision framework for ethical investing, the investor must define what they consider to be an immoral company. One author has stated that "*what is wrong investing in an immoral company is not that one is necessarily providing the resources whereby it can engage in wrongdoing, but that even in the absence of providing such resources, one implicitly condones its immoral behavior*"<sup>3</sup>. By the investor determining whether they are condoning immoral behavior, the investor can still invest in some companies, but must enact their moral duty to reprimand the company's officers and effect change from within.

### Ethical Categories

To facilitate the decision making we have divided immoral companies into three categories:

- Type 1:** A company whose prime or major business is directly involved in the manufacture or production of a good or service whose primary use is clearly immoral.

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<sup>1</sup> Solomon, Lewis D., Coe, Karen C., "The Legal Aspects of Social Investing by Non-Profit Fiduciaries", The Journal of Investing, Winter 1997.

<sup>2</sup> McKeown, W.B., "On Being True to Your Mission: Social Investments for Endowments", The Journal of Investing, Winter 1997.

<sup>3</sup> Irvine, William B., "The Ethics of Investing", Journal of Business Ethics 6 (1987) 233-242.

**Type 2:** A company which engages in immoral acts while producing a good or service.

**Type 3:** A company which invests in, or provides a service which promotes and assists either a directly immoral company or behaviorally immoral company.

Primary Type 1 companies would be tobacco and gambling companies. A secondary Type 1 company would be producers of alcohol and weapons. The alcohol and weapons companies are a secondary Type 1, since it is not the use of alcohol but rather its misuse that creates social problems, with a similar case being made for weapons (the police, UN peace keepers, and the concept that weapons act as a deterrent to aggression.) A tertiary Type 1 is where a debate exists as to whether the product is in fact unethical. A manufacturer of birth control or abortion drugs (Life Ethics) would be considered unethical by some, and not by others.

A Type 2 company can fall into a number of categories. Some of these categories are Environmental, Animal Rights, Diversity of Workforce, Corporate Behavior Towards Employees and Investment in Dictatorship Countries.

Examples of potential environmental violators are forestry, mining, oil & gas companies and waste management companies. In this instance, the violations can be due to insensitive business practices as opposed to the core activity (although forestry could be seen as a Type 1 industry by some). Workforce Diversity, Corporate Behavior and investing in totalitarian states are not industry or product specific categories.

The investor faces a more complex decision process in dealing with Type 2 companies. Determining which companies are acting immorally can be a very subjective decision. Also, investors should remember that their influence and responsibilities extend beyond the decision to buy or sell stock. As an equity investor, they are also owners in the company. The ethical investor may find that they can wield much greater influence by owning shares, voting their proxies and attending shareholder meetings, than by not purchasing stock. Albeit, successful proxy battles in Canada are an extremely rare occurrence.

The most tenuous criteria, is the setting of ethical constraints for Type 3 companies. They may or may not be aware that their support of other companies results in the suffering of others. A clear set of guidelines is difficult to construct. The best approach for the investor is to stay vigilant and aware of what the companies they invest in are doing and if they are aware of an ethical violation, act – either through voting with their proxy or with their feet.

## **Ethical Portfolio Construction**

When constructing an ethical portfolio, the methodology is not to find ethical companies, but rather to omit unethical companies from the portfolio. The investor creates a “Social Screen” to remove unethical companies from the list of companies in which they can invest. The following table is a list of “Social Screens”, and their prevalence in the investment industry<sup>4</sup>.

<b>Social Screen</b>	<b>Screening Prevalence</b>
Alcohol	High
Tobacco	High
Gambling	High
Life Ethics	High
South Africa	High / Low*
Nuclear Power	Moderate
Animal Testing	Moderate
Human Rights	Moderate
Military	Moderate
Environment	Moderate
Union Relations	Moderate
Diversity	Low
Profit-Sharing	Low
Layoffs	Low
R&D Spending	Low
Product Liability	Low
Executive Pay	Low
Corporate Crime	Low
Charitable Giving	Low
Plant Closings	Low

\* South Africa went from high during apartheid, to low after the change in government in 1995.

In applying a Social Screen, the investor’s main concern is how such a screen would impact their portfolio performance. A number of studies have been performed in the United States on this subject, with the general conclusion that moderately applied social screens do not improve performance nor do they reduce performance<sup>5</sup>. This is an important result, since advocates and critics of socially responsible investing frequently use ad hoc evidence to support their claims.

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<sup>4</sup> Kurtz, Lloyd, “No Effect, or No Net Effect? Studies on Socially Responsible Investing”, The Journal of Investing, Winter 1997.

<sup>5</sup> Guerard, J.B. Jr., “Is There a Cost to Being Socially Responsible in Investing?” Journal of Investing, Summer 1997.

To determine how a social screen would impact a large capitalized Canadian portfolio, we have taken the TSE 35 Index, and screened on a number of criteria. The TSE 35 constituents for the past decade, and a description of each is listed in the following table.

### **TSE 35 Constituents**

<b>Code</b>	<b>Name</b>	<b>Industry</b>	<b>Summary</b>	<b>Ethical Consideration</b>
A	Abitibi-Consolidated	Paper and Forest Products	Manufactures and markets newsprint, value-added papers, and distributes office products.	Forestry
ABX	Barrick Gold	Gold and Precious Minerals	Gold mining, exploration, development and processing.	Mining
AC	Air Canada	Transportation and Environmental Services	International air carrier.	No
AGT	Telus Corporation	Utilities	Full range of telecommunications services.	No
AL	Alcan Aluminum	Metals and Minerals	Aluminum refining, mining, smelting and recycling.	Mining
BBD.B	Bombardier CI B	Transportation Equipment	Global manufacturing of transportation, aerospace and motorized consumer products.	Weapons
BCE	BCE Inc.	Utilities	Supplies telecommunication and other wireless communication services and equipment.	No
B	BCE Inc.			
BMO	Bank of Montreal	Financial Services	Bank	No
BNS	Bank of Nova Scotia	Financial Services	Bank	No
BVI	Bow Valley Industries	Oil and Gas	Petroleum exploration and production.	Oil drilling
CAE	C.A.E. Industries	Industrial Products	Designing, manufacturing and marketing flight simulators for commercial and military markets.	Weapons
CM	Canadian Imperial Bank	Financial Services	Bank	No
CNR	CNR Co.	Transportation and Environmental Services	Operates one of Canada's railroad systems.	No
CP	Canadian Pacific Ltd.	Conglomerates	Core businesses include CP Railway, Ships, PanCanadian Petroleum, Fording, and CP Hotels.	Oil drilling
CTR.A	Canadian Tire Corp. A	Merchandising	Hard-good retailers of automotive, sports, leisure, and home products.	No
CXY	Canadian Oxy Petroleum	Oil and Gas	Exploration, development, production, and marketing of crude oil, natural gas and related, and alternate fuels and chemicals.	Oil drilling

DFS	Dofasco Inc.	Industrial Products	Steel maker, makes hot and cold-rolled galvanized and tin plated steels for auto, construction, container, appliances and tubular uses.	No
DM	Dome Mines	Gold and Precious Metals	Exploration, acquisition, development and operation of mineral properties (including gold, silver, copper and molybdenum).	Mining
ECO	Echo Bay Mines	Gold and Precious Metals	Processes and explores for gold and silver in Canada and US.	Mining
FL	Falconbridge	Metal and Minerals	Explores, develops, mines, processes and markets a variety of metals and minerals including nickel, copper, zinc, cobalt, etc..	Mining
GOC	Gulf Canada	Oil and Gas	Exploration, development, production and marketing of conventional and synthetic crude oil, natural gas liquids and natural gas.	Oil drilling
GOU	Gulf Canada Resources			
IMO	Imperial Oil	Oil and Gas	Producer of crude oil and natural gas, refiner and marketer of petroleum products, and is a supplier of petrochemicals.	Oil drilling
IMO.A	Imperial Oil A			
IMS	Imasco Ltd.	Consumer Products	Operates Imperial Tobacco, Shoppers Drug Mart/Pharmaprix, Genstar developments Co. CT Fncl. Services and Fast Food Merchandisers.	Tobacco
ITO	International Thomson	Communications and Media	Information and publishing concentrated in delivering information-based services and tools to industry, government and academia.	No
TOC	Thomson Corporation			
LAC	Lac Minerals	Gold and Precious Metals	Gold exploration and processing.	Mining
LDM	Laidlaw Inc.	Transportation and Environmental Services	School bus and public transit services, healthcare transportation services, and management of physicians services in Can and US.	No
LDM.B	Laidlaw CL.B			
MB	MacMillan Bloedel	Paper and Forest Products	Integrated forest products company operating in engineered lumber, solid wood, distribution and packaging.	Forestry
MCL	Moore Corp.	Industrial Products	Provides business forms, printing services, labels and label systems, and personalized direct mail services.	No
MG.A	Magna Int'l CI A	Industrial Products	Designs, engineers and manufacturers a complete range of exterior and interior vehicle systems.	No

MHP	Maclean-Hunter Ltd.	Communications and Media	Information publishing.	No
N	Inco Ltd.	Metals and Minerals	Produces nickel, copper, cobalt, precious metals and alloy components for industrial applications.	Mining
NA	National Bank	Financial Services	Bank	No
NOR	Noranda Mines	Metals and Minerals	Operates in mining and metals.	Mining
NTL	Northern Telecom	Industrial Products	Designs, develops, manufactures, markets, sells, finances, installs and services digital telecommunications systems.	No
NVA	NOVA Corp.	Industrial Products	Manufactures and markets petrochemicals, operates natural gas and liquid pipelines and explores, develops, transports, and markets energy products.	Oil drilling
NVA.A	Nova Alberta CL.A			
PCA	Petro-Canada	Oil and Gas	Markets crude oil, natural gas and propane, and refines crude oil into petroleum products.	Oil drilling
PDG	Placer Dome	Gold and Precious Metals	Exploration, acquisition, development and operation of mineral properties (including gold, silver, copper and molybdenum).	Mining
PDL	Placer Development	Gold and Precious Metals		
POW	Power Corp.	Conglomerates	Communications including newspapers, printing, publishing, television and radio, and financial services.	No
RCI.B	Rogers Com. CI B	Communications and Media	Cellular and other wireless communications, cable television and other cable distribution services, publishing, and radio and television broadcasting.	No
RES	Renaissance Energy	Oil and Gas	Oil and gas producer.	Oil drilling
RGO	Ranger Oil	Oil and Gas	International exploration, development and production of crude oil and natural gas.	Oil drilling
RY	Royal Bank	Financial Services	Bank	No
SCC	Sears Canada	Merchandising	Full-line department stores.	No
STE.A	Stelco Ser.A	Industrial Products	Produces various types of steel.	No
STM	Southam Inc.	Communications and Media	Newspaper publisher.	No
SU	Suncor Energy Inc.	Oil and Gas	Integrated oil and gas company with three operating segments: Oil Sands, Exploration and Production, and	Oil drilling

			Sunoco.	
TA	TransAlta Corp	Utilities	Generates, distributes and markets energy (95 % of production is thermal (coal) base, remainder is hydro).	No
TAU	TransAlta Utilities			
TAU.A	TransAlta Utilities A			
TD	Toronto Dominion Bank	Financial Services	Bank	No
TEK.B	Teck Corp. CI B	Gold and Precious Metals	Mines and produces copper, gold, coal, zinc and other ores, primarily through joint ventures.	Mining
TLM	Talisman Energy	Oil and Gas	Upstream oil and gas producer.	Oil drilling
TRP	TransCanada Pipelines	Pipelines	Transmits, markets and processes energy.	No
TVX	TVX Gold	Gold and Precious Metals	Acquires, finances, explores, develops, and operates precious metal properties.	Mining
VO	Seagrams	Consumer Products	Production and marketing of distilled spirits, wines, fruit juices, coolers and mixers, and produces and distributes motion pictures, television products and recorded music.	Alcohol

Our screening is based on what the company does as opposed to how they carry on their business activities. The major difficulty with social screening based on business practices is the high degree of subjectivity and the lack of definitive objective information available to the investor. Corporate public relations departments, the media, political, health and environmental groups all have their own mandates, and release information to advance those mandates. A well constructed and measured approach must be used if the investor seeks to apply business practice screens.

One criticism of using a social screen based on what a company does, is the tendency of the screen to tilt the portfolio towards a sector bias. The dominant style can become industry selection. Another criticism is the investor may omit “clean” companies in “dirty” businesses, and include “dirty” companies in “clean” businesses. No screen will be perfect, and the investor should balance the level of effort of refining their social screen against the efficacy in advancing their core mandate.

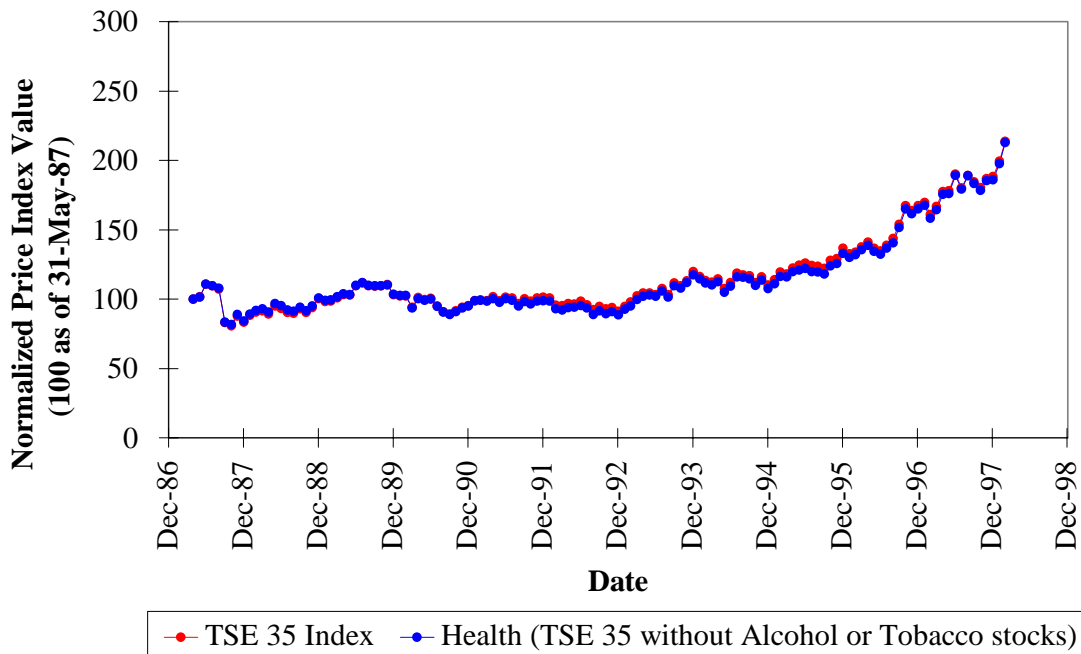
The results of this analysis is listed in the following table, with the average annual return and annual tracking errors for various social screens. (A tracking error describes the percentage deviation of the portfolio from the index)

	Average Annual	Annual Tracking
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	<b>Return (Jun 87 - Mar 98)</b>	<b>Error (Jun 87 - Mar 98)</b>
TSE 35 Index	7.32%	-
<b>Ethical Constraints</b>		
No Alcohol	7.36%	1.10%
No Tobacco	7.23%	0.60%
<b>Health</b> (No Alcohol or Tobacco)	7.27%	1.41%
No Weapons Manufacturers	7.24%	0.49%
<b>People</b> (No Alcohol, Tobacco or Weapon Manufacturers)	7.18%	1.47%
No Mining	8.78%	4.02%
No Forestry	7.42%	0.48%
No Oil & Gas	8.01%	2.23%
<b>Environment</b> (No Mining, Forestry or Oil & Gas)	10.18%	5.42%
<b>Total Ethical</b> (People and Environment Constraints)	10.51%	6.08%

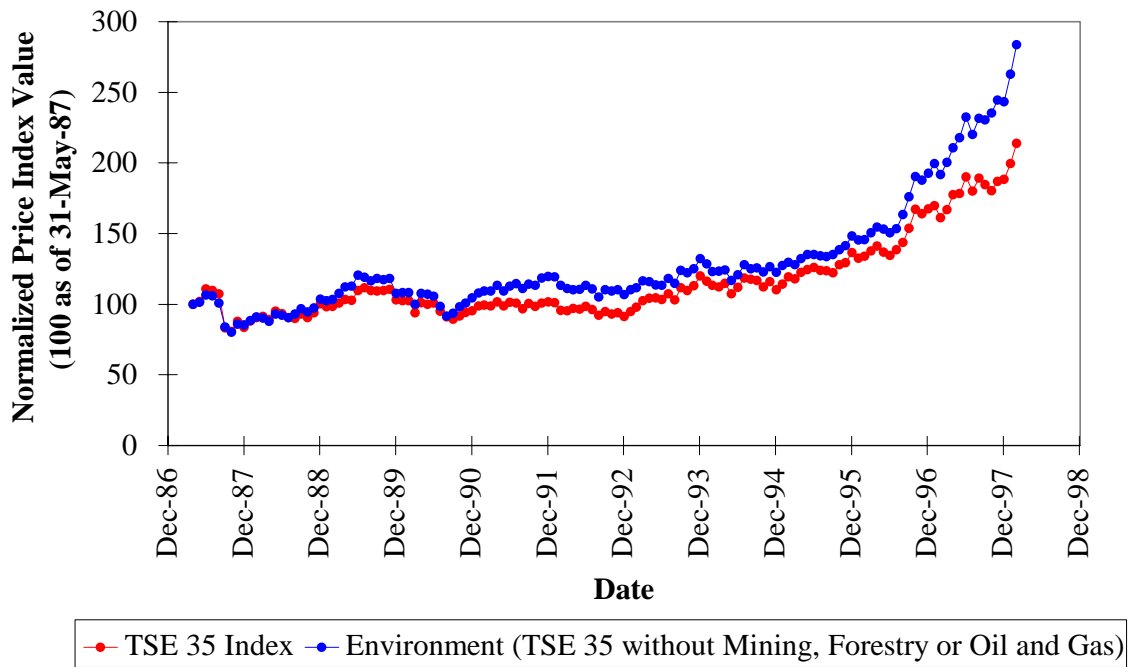
From this table and the following graph, we can see that the removal of Alcohol and Tobacco stocks (Seagrams & Imasco) had no appreciable impact on the portfolio's results. Seagram's drift into the entertainment industry caused the company to underperform the broader market in recent years, and Imasco's performance was similar to that of the broader market.

### Ethical Investing (Health): Comparative Historical Performance



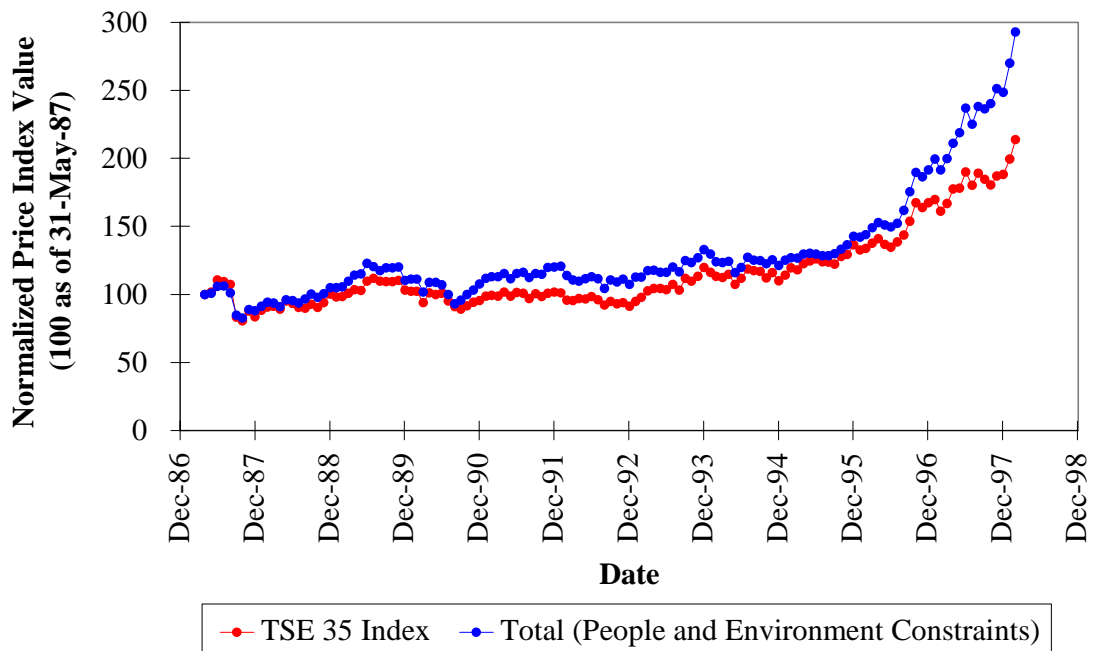
The Environment portfolio (No mining, forestry, oil & gas) has substantially outperformed the broader index in the past decade. The low value of commodities (especially in recent years), the Bre-X fiasco, and the movement of the Canadian economy away from the resource sector and towards services and manufacturing, are all contributing factors. As one would expect, with a substantially higher performance, the tracking error for this portfolio is higher as well.

### Ethical Investing (Environment): Comparative Historical Performance



Full screening on all industry related ethical considerations generates a portfolio which substantially outperformed the TSE 35 Index. This is primarily due to the exclusion of resource based stocks from the portfolio.

### Ethical Investing (Total): Comparative Historical Performance



## Summary

Socially Responsible Investing is likely to become more prevalent in the coming years. With no material difference between a Socially Responsible portfolio and a regular portfolio, in both the U.S. and Canadian markets, more investors will be adding social screens to their investment policies. For institutional investors, the most important aspect to adding a social screen is to perform due diligence in determining how that screen will impact a portfolio's long term performance.