ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

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ESG Investing: It's Complicated

What is ESG investing? Almost one in four retail investors in the United States believes that ESG stands for "Earnings, Stock and Growth." This revelation comes from a recent study conducted by the National Opinion Research Center and the FINRA Investor Education Foundation.[1] Only 21% of the 1,228 people surveyed knew that ESG actually refers to Environmental, Social and Governance factors.

From our perspective, it's not surprising that individual investors struggle to understand ESG investing. The ESG landscape is like the Wild West, with few rules and standards. It also means different things to different people, and the rating agencies that evaluate corporations on ESG factors have varied methodologies and often provide conflicting scores. Nonetheless, professionally managed assets with ESG mandates, such as mutual funds and ETFs, have swelled in popularity, largely because they are marketed on the basis that ESG investing delivers superior performance. While we generally agree with the premise that "doing good is good business," as explained by Equity Analyst Stephen Boland in the March 2021 *Odlum Brown Report*, the conclusion doesn't always hold true for investors. Popular strategies sometimes yield excessive valuations, which can undermine performance. Lately, investors are grappling with the devastation in Ukraine and debating whether it alters the relative importance of each individual ESG factor. What does one do when the E and the S are in direct conflict? (More on that later.) Not surprisingly, the discussion has intensified as ESG-oriented funds have underperformed the broader market indices in the first quarter of 2022.

Environmental, social and governance criteria are rightfully and increasingly important to society, and they have always been key considerations in Odlum Brown's process of selecting securities for client accounts. We think like business owners, and believe in owning firms run by good corporate citizens. How a business treats its customers, employees, suppliers and community influences its competitive position, profitability and growth prospects. As such, ESG factors are integral to our due diligence, alongside traditional financial analysis, when considering investment opportunities.

Responsible or ESG investing is a complex and confusing subject, and it's useful to have a base understanding of the three major approaches:

ESG Integration: This is the most widely used approach and the one employed by the Odlum Brown Research Department. It involves the assessment of material ESG risks and opportunities, alongside traditional financial analysis in the investment process.

Socially Responsible Investing (SRI): This entails negative screening or limiting the investment universe based on predetermined criteria. For some, it means not investing in areas like fossil fuels, tobacco or firearms. The approach aims to align investments with a specific set of values or beliefs.

Impact Investing: Investing in businesses that are trying to solve problems such as climate change, quality of education or poverty.

Our clients have varied ESG objectives, and we are able to tailor portfolios to their unique needs, constraints and preferences, as all accounts are fully segregated with individual securities and/or products. Our Investment Advisors and Portfolio Managers oversee these personalized client accounts and can incorporate one, two or all three of the common approaches to responsible investing, based on a client's preferences.

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BC Children's Hospital Foundation – Jean Up
May 2022
Throughout BC

Odlum Brown has proudly supported the BC Children's Hospital Foundation for almost 30 years and has sponsored Jean Up for over a decade. Jean Up is an annual online initiative for British Columbians to come together and wear jeans to help sick and injured kids get out of their hospital gowns and back into their own jeans.

Odlum Brown is proud to be the School Match Sponsor of Jean Up, matching donations made through schools' fundraising pages up to $30,000 throughout the month of May. Support for this initiative will fund everything from innovative research and equipment to specialized care that's tailored to the unique needs of kids.

For more information, visit jeanup.ca.

In addition to our own analysis, we monitor insights from third-party rating agencies like MSCI, S&P Global Ratings and Morningstar's Sustainalytics. While the outside research is valuable, one has to critically evaluate their conclusions. Companies will often receive a high ESG grade from one agency and a low mark from another. Studies have demonstrated that these inconsistencies are widespread. In a recent CFA Institute blog post titled "ESG Ratings: Navigating Through the Haze,"[2] Kevin Prall, Business Valuation Standards Director at the International Valuation Standards Council, looked at six separate ESG ratings providers for over 400 companies across 24 industries. After developing a scoring system to harmonize ratings across providers, Mr. Prall found an extremely low level of correlation. For instance, MSCI's ESG ratings' correlation with S&P Global's and Sustainalytics' was less than 36%. The correlation between S&P Global and Sustainalytics was higher at 65%, but still indicates significant discrepancies. For context, consider that the correlation of long-term debt ratings from the three big credit rating agencies – S&P Global, Moody's and Fitch Ratings – for the same companies was approximately 95%. Calculating the likelihood that a company will repay its debt is clearly more of an exact science, whereas assessing ESG factors and assigning a grade involves a higher degree of subjectivity.

This doesn't mean third-party research isn't useful; it is. However, one has to appreciate that each provider uses different methodologies and factor weightings.

According to the Deloitte Center for Financial Services, professionally managed assets with ESG mandates swelled to $46 trillion in 2021, representing nearly 40% of all assets under management. The rising popularity of ESG funds has been fueled by impressive performance, yet critics argue that the industry has oversold this success. Critics contend that much of the superior performance over the last decade can be attributed to ESG funds' tendency to overweight technology equities, which have outperformed, and underweight fossil fuel stocks, which have underperformed until recently. The war in Ukraine and rising inflation are benefiting energy stocks and are weighing on the valuations of technology stocks; as a result, ESG-focused funds are underperforming. *Barron's Magazine* dramatically declared, "Sustainable Investing Failed Its First Big Test. A Reckoning is Coming"[3] in its cover story on April 17, 2022. While the author, Lauren Foster, acknowledges that one quarter of poor performance does not constitute a trend, we wonder how, or whether, this investment strategy will evolve in response to changing sentiments.

The war in Ukraine is forcing investors to think more broadly about ESG factors. Climate change and environmental issues often take centre stage in ESG discussions, but there is a growing awareness of pressing social considerations. Fast-rising energy prices act like a tax on consumers, and low-income households are hurt disproportionately. That has caused governments to subsidize high energy prices by lowering fuel taxes and/or distributing money. Likewise, President Biden's decision to release significant amounts of oil from the Strategic Petroleum Reserve runs counter to efforts to limit climate change. The E and the S in the ESG equation are in conflict with each other in this instance when thinking about climate change and inequality.

With Europe overly reliant on Russian oil and gas, there is an increased interest in accelerating the pursuit of secure sources of clean energy. At the same time, there is an elevated appreciation for access to fossil fuels from friendly sources in the West, to bridge the transition to a greener world. Many argue that Europe should buy Canadian oil and gas rather than finance Putin's war efforts by buying them from Russia.

Investors are also rethinking how the defense industry fits within the ESG context. Prior to Russia's invasion of Ukraine, the general view was that such businesses didn't belong in ESG-focused funds. After all, defense companies make products that kill people, and those products are often sold to bad actors. However, the world doesn't look as secure as it did a couple of months ago, and defense spending is increasingly seen as a necessity to protect democracy.

ESG considerations are complex and nuanced, and the individual factors can conflict with one another. That is why there is so much variability in third-party ratings. It's also why ESG discussions can be controversial. We will continue to apply a holistic approach to ESG considerations, and strive to deepen our understanding of the issues. Most importantly, we will work with our clients to structure portfolios that are suited to their individual perspectives and needs.

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[1] https://www.finrafoundation.org/sites/finrafoundation/files/Consumer-Insights-Money-and-Investing.pdf
[2] https://blogs.cfainstitute.org/investor/2021/08/10/esg-ratings-navigating-through-the-haze/
[3] https://www.barrons.com/articles/esg-investing-big-test-reckoning-51650041442?mod=past_editions (Subscription Only)

2022 Federal Budget Highlights

On April 7, 2022, Canadian Deputy Prime Minister and Minister of Finance Chrystia Freeland delivered the government's 2022 Federal Budget, forecasting a deficit of $113.8 billion for the 2021-2022 fiscal year[1] and $52.8 billion for 2022-2023. Here is a brief overview of some of the notable proposals affecting individuals, corporations and charities.

Personal and corporate tax rates remain unchanged[2] and, despite speculation, the Budget did not address an increase to the capital gains inclusion rate, a wealth tax, nor changes to the principal residence exemption.

Individuals

Home Buyers/Owners

The government introduced a number of measures to address home ownership and affordability.

Tax-Free First Home Savings Account (FHSA)

Budget 2022 proposes a new Tax-Free First Home Savings Account (FHSA) to allow prospective first-time home buyers[3] to make tax-deductible contributions of up to $8,000 per year, up to a lifetime maximum of $40,000. Income earned in the account is not subject to tax, and qualifying withdrawals are non-taxable.

To open an FHSA, you must be at least 18 years old and a resident of Canada, and you cannot have lived in a home that you owned in the year the account is opened or in the previous four calendar years.

If funds in the account have not been used to make a qualifying first home purchase within 15 years of first opening the FHSA, the account must be closed. Unused savings could be transferred to an RRSP or RRIF, or withdrawn as a taxable amount. After making a qualifying withdrawal, you must close your FHSA within a year of the first withdrawal and are ineligible to open another FHSA.

While the Home Buyers' Plan (HBP) will continue to allow tax-free RRSP withdrawals of up to $35,000 to buy or build a qualifying home, individuals will not be allowed to make both HBP and FHSA withdrawals for the same home.

First-time home buyers can expect to start making FHSA contributions in 2023.

New Multigenerational Home Renovation Tax Credit

Starting in 2023, this new tax credit could provide up to $7,500 in support for building a secondary suite for a family member who is a senior or an adult with a disability, based on a 15% refundable credit on up to $50,000 in eligible renovation and construction costs.

Expenses claimed under the Medical Expenses Tax Credit and/or existing Home Accessibility Tax Credit will not be eligible for the Multigenerational Home Renovation Tax Credit.

Increase to Home Accessibility Tax Credit

The Home Accessibility Tax Credit limit is proposed to double for the 2022 tax year, offering tax savings up to $3,000 for eligible Canadians, based on 15% of eligible renovation expenses of up to $20,000.

Increase to First-Time Home Buyers' Tax Credit

The Budget proposes to double the First-Time Home Buyers' Tax Credit base amount to $10,000. The enhanced credit would provide up to $1,500 in direct support for a home purchase made on or after January 1, 2022.

Taxing Property Flipping as Business Income

Budget 2022 proposes new rules to tax as business income profits earned by individuals who sell residential real estate that has been held for less than 12 months. Under the new rules, such profits are not eligible for the 50% capital gains inclusion rate nor the Principal Residence Exemption (PRE).

Exemptions will be provided for certain life events, such as a sale due to death, divorce, a new job, a new child or a disability.

The measure would apply to residential property sales on or after January 1, 2023.

GST/HST Tax on Assignment Sales

Currently, Goods and Services Tax/Harmonized Sales Tax may or may not apply when a person makes a new home assignment sale, depending on the reason for purchasing the home. To clarify when GST/HST applies and mitigate potential dishonesty by speculators, all assignment sales of newly constructed or substantially renovated residential housing would be GST/HST taxable, effective May 7, 2022.

Other

Moving toward a minimum tax for high earners

The Budget announces a commitment to explore a new minimum tax regime, which will go further toward ensuring that all wealthy Canadians pay their fair share of tax. The government will release details on a proposed approach in the 2022 fall economic and fiscal update.

Reporting Requirements for RRSPs and RRIFs

Financial institutions are currently required to annually report to the Canada Revenue Agency (CRA) any withdrawals from, and contributions to, each Registered Retirement Savings Plan (RRSP) and Registered Retirement Income Fund (RRIF) they administer. The Budget introduces a further requirement to report the total year-end fair market value of assets held in each RRSP and RRIF they administer.

Consistent with existing reporting requirements for Tax-Free Savings Accounts (TFSAs), this additional information is meant to "assist the CRA in its risk-assessment activities regarding qualified investments held by RRSPs and RRIFs" and is applicable to the 2023 and subsequent taxation years.

Flow-Through Shares for Oil, Gas and Coal Activities

Budget 2022 proposes to eliminate the flow-through share regime for oil, gas and coal activities by no longer allowing oil, gas and coal exploration or development expenditures to be renounced to flow-through share investors.

This change would apply to expenditures renounced under flow-through share agreements entered into after March 31, 2023.

Medical Expense Tax Credit for Surrogacy and Other Expenses

The Medical Expense Tax Credit (METC) provides a 15% non-refundable tax credit for qualifying medical expenses in excess of the lesser of $2,479 and 3% of net income.

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Budget 2022 proposes to expand the METC to cover medical expenses paid by taxpayers or their spouses or common-law partners with respect to reproductive technologies and procedures for surrogates and donors of sperm, ova or embryos. Fees paid to fertility clinics and donor banks in Canada will be eligible under the METC.

This measure would apply to expenses incurred in the 2022 and subsequent taxation years.

Corporations

Small Business Deduction

Small business corporations benefit from a reduced federal corporate tax rate of 9%, compared to the general corporate rate of 15%. This rate reduction is available to Canadian-controlled private corporations (CCPCs) via the small business deduction (SBD) on up to $500,000 per year of qualifying active business income.

The $500,000 business limit is reduced on a straight-line basis when a CCPC (and any associated corporations) has taxable capital in Canada between $10 million and $15 million, or "adjusted aggregate investment income" between $50,000 and $150,000. The business limit is the lesser of the two amounts determined by these reductions.

The Budget proposes to increase the taxable capital range over which the business limit is reduced to between $10 million and $50 million.

This measure would apply to taxation years that begin on or after April 7, 2022.

Intergenerational Share Transfers

The Budget announced the commencement of a consultation process to review tax issues relating to intergenerational share transfers and the surplus stripping rules.

Substantive CCPCs

The Budget proposes that for taxation years ending on or after April 7, 2022, investment income earned by a private corporation residing in a foreign jurisdiction, but controlled by a Canadian resident taxpayer, will be subject to the same tax rules as other Canadian-controlled private corporations (CCPCs).

Charitable Organizations

The Budget calls to increase the disbursement quota by registered charities to 5% (from 3.5%) for the portion of investment assets in excess of $1 million.

The disbursement quota is the minimum calculated amount that a registered charity is required to spend each year on its own charitable programs or on gifts to qualified donees, such as other registered charities.

Budget 2022 can be viewed online in its entirety on the Department of Finance Canada's website[4] and is subject to parliamentary approval.

For more information, please contact your Odlum Brown Investment Advisor or Portfolio Manager.

MICHAEL EREZ, CPA, CGA, CFP®
Vice President, Director
Odlum Brown Financial Services Limited

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[1] Ending March 31, 2022.
[2] Exceptions for major financial institutions: A 1.5% increase to the corporate income tax rate to 16.5% (from 15%) on the taxable income of banking and life insurance groups above $100 million, and a Canada Recovery Dividend, which is a one-time 15% tax on taxable income above $1 billion for the 2021 tax year, payable in equal installments over five years.
[3] You are considered a first-time home buyer if, in the four-year period, you did not occupy a home that you or your current spouse or common-law partner owned.
[4] budget.gc.ca/2022/home-accueil-en.html

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