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The Search for Sustainable Long-Term Investments

The topic of Environmental, Social and Governance (ESG) investing is one that continues to gain in popularity. ESG investing can have different meanings to individual investors, and ESG principles can be incorporated into investment processes in a multitude of ways. At Sionna, we thought it would be worthwhile to share our interpretation of ESG principles and how we apply them to our research process.

The foundation of Sionna's investment process is our rigorous research, which seeks to identify quality businesses with solid competitive positions and capable management teams. We invest in businesses that are trading below our estimate of their intrinsic value, which we base on our assessment of the company's long-term potential. Sionna has always looked beyond financial statements when judging a company's potential and we firmly believe in evaluating investments through a broad lens. As a result, we try to consider the significant issues that could impact the returns of an investment, including ESG factors, among many others.

Environmental factors relate to a company's interactions with the physical environment. Sionna considers issues such as carbon emissions and climate impact, resource management and pollution prevention, and environmental disclosures. For a fossil fuel company, for example, we would be mindful of the potential impact of carbon taxes and the implications of climate change policies. For a mining company, we would examine site rehabilitation liabilities on the balance sheet, and consider whether there are adequate reserves being set aside. We regularly meet with the management teams of our investee companies to assess their understanding of their particular vulnerabilities, as well as their opportunities. When environmental factors are managed correctly, a company can reduce costs, improve profitability and lessen regulatory and litigation risk.

Social factors are those that concern the impact of a company on a community or society. Sionna considers issues such as worker health and safety, human rights and employment relations. For a manufacturing company, for example, we would look at its history of safety issues. For a retailer with a unionized workforce, we would assess its management of labour relations. If social factors are well managed, a company may see an increase in productivity, improvements to its reputation, and development of brand loyalty.

Governance factors are those that relate to how companies are governed at the executive and board level. Sionna considers issues such as executive compensation, board accountability and shareholder rights. We typically examine a company's compensation program to see how the management team is paid, which metrics are used to determine bonuses and how much compensation is awarded in cash versus shares. We evaluate the members of the board based on their degree of independence and their commitment to upholding shareholder and stakeholder interests. We use our proxy votes to voice our concerns on board matters and Sionna is an active member of the Canadian Coalition for Good Governance, which promotes good governance practices in Canadian public companies. If governance issues are well managed, a company is better able to properly align the interests of shareholders and management, and incentivize behaviour that drives returns and profitability over the long term.

Sionna's research process is designed to identify companies that can prosper over the long term. We encourage critical thinking and integrated analysis, which involves evaluating companies from a broad perspective, including consideration of ESG factors. Well-managed ESG issues may contribute to stronger returns on capital, while poor practices may hinder a company's earning power. ESG factors alone do not drive our investment decisions; however, they do help to inform our analysis. A proper evaluation of a company's exposure to these factors helps Sionna to determine what long-term returns to anticipate from a company, what level of risk to account for and what margin of safety we should demand on our investment. By understanding the fundamentals of a business and what obstacles may challenge our thesis on a company, we can properly manage risk and remain good stewards of our clients' capital.

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