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Blue Heron Portfolios – Better Is Better

The Blue Heron Wealth Management Approach

Our clients see us as trusted family advisors who **respond** as their needs evolve throughout their lifetime.

Taking a **patient** long-term approach to managing your wealth means we build long-term, trusted relationships with you and your family.

When a number of our clients asked about Socially Responsible Investing (SRI), we created our own diversified, blue-chip sustainable portfolios which are **distinct** from other, more traditional SRI options.

Our positive screening allows your core portfolio to be invested in only the most committed, innovative and **sustainable** companies.

Our investment principles, rigorous methodology and our **watchfulness** can lower your risk and increase your returns.

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Blue Heron Portfolios – Better is Better

We sat down at the end of January 2013 to discuss jointly managing a portfolio. The original idea was to create a jointly managed Advisor Managed Account model that focused on global equities that we could both offer our clients. We wanted to build something that would complement our existing, actively managed Canadian focused models. As we discussed the possibilities, it became clear that we both had clients who expressed a strong interest in Socially Responsible Investing (SRI) and we both had trouble finding anything in the marketplace that met our clients' expectations. We left the meeting agreeing that we should create both a Global and a Canadian Focused portfolio model that in the spirit of efficiency, met our clients' SRI expectations while being suitable for clients who did not hold SRI as a priority (i.e., they should make money). We went away to do more research.

We agreed that the available SRI investment vehicles (mutual funds, separately managed accounts (SMA), and exchange traded funds (ETFs) fell short of our clients' expectations. Institutional investors dominate the SRI space in Canada with over $530 billion of the $600 billion in assets controlled directly by pension funds versus the $13.5 billion SRI retail mutual fund market (all 2011 figures from Sustainable Investment Organization). Thus, the SRI investments available to retail investors are mostly adapted from "institutional" mandates and therefore reflect the needs of very large investors with near infinite time horizons and who are very rigidly evaluated relative to the stock market benchmark.

This rigid relative evaluation goes beyond performance and extends into the need to mimic the benchmark in all behaviors including sector weightings, stock weightings and volatility, in an effort to reduce "tracking error." The best, and easiest, means to track the index is to replicate the index. Thus, a typical institutional SRI mandate is an effort to meet specific, often limited, SRI criteria with the aim of reconstituting and mimicking the index with a minimum of tracking deviation. The specific, limited and often single issue SRI criteria employed in these products is tailor-made to allow for effectively tracking the index. However, it fails to meet the social and environmental concerns that our clients have voiced. For a retail investor, this active attempt to passively match the index is packaged into a product that is typically more expensive than active management and significantly more expensive than passive index investing. High fees with a passive mandate are a virtual guarantee of underperformance and unhappy clients.

We took a different approach to SRI because, unlike institutional investors, our clients do not benefit from an infinite time horizon and do not come to the table with only a single SRI issue. In our approach, we agreed on key criteria:

- The aim of our SRI portfolio models, like our existing portfolios, should be to outperform their benchmark indices on a risk-adjusted basis, over a five-year time horizon.
- The SRI portfolios must be of similar risk to our existing portfolios in order to have a broad appeal and applicability to our clients. We were not interested in a niche product, but instead a portfolio that a reasonable investor could hold as their core or sole equity portfolio.
- Our SRI portfolios should not be priced at a premium to our existing portfolio models.
- Our investment approach must have a reasonable academic basis with a systematic, objective and repeatable process.
- Our solution must be demonstrably "better" than what is available.

As we researched the issue, we read a June 2012 report from Deutsche Bank (DB) called *"Sustainable Investing – Establishing Long-Term Value and Performance"* that analyzed 56 research papers, two literature reviews, and four Meta studies. This report made the following key conclusions:

- There is overwhelming academic evidence, within all (100%) of the studies that DB analyzed, showing that firms with high ratings for Corporate Social Responsibility (CSR) and Environmental, Social and Corporate Governance (ESG) factors have a lower cost of capital in terms of debt and equity. In a fundamental sense, they are of lower risk.
- There is compelling academic evidence that high ratings for CSR and ESG are correlated with Corporate Financial Performance (CFP) outperformance, both market and accounting based. All (100%) of the studies that DB analyzed showed that high CSR-scoring firms exhibited financial outperformance, while 89% and 85% of the studies showed that firms with high ratings for ESG (or E, S or G) exhibited market based or accounting based outperformance, respectively.
- SRI fund managers have struggled to capture this outperformance and in general have had neutral results. This is primarily because they used either exclusionary criteria to eliminate the worst CSR and ESG companies or a single/limited issue exclusionary screening as opposed to an approach that identifies and invests in companies with high CSR and ESG screening.

We believe that DB's findings provides an effective framework to remove most of the subjectivity from our environmental, social and corporate governance (ESG) screening to create a reasonable, objective, and repeatable methodology that helps identify the best rated ESG companies. This could then be crafted into a diversified SRI portfolio with a predisposition to lower financial risk and outperformance. We summarize this as: "Better is… better." We have published our methodology as the "Blue Heron Portfolios: Investment Principles," which provides considerable detail into how the companies identified in our "Investable Universe" are identified. These principles are available on our website:

www.smartsustainableinvesting.com

In January 2013, we had a good idea. After considerable thought, effort, and financial investment we launched Blue Heron Global Equity in August 2013, which was followed by Blue Heron Canadian Focused Equity in September 2013. These two portfolios meet the criteria that we established at the beginning of the process, and have resulted in diversified blue-chip portfolios which are distinct from other, more traditional SRI options.

We have now achieved 1 Year audited returns that can be published and are available on our website. These returns are better than the benchmark. Portfolio analytics confirm that our methodology has resulted in a portfolio that screens for Environmental, Social and Corporate Governance factors better than the benchmark (objectively better).