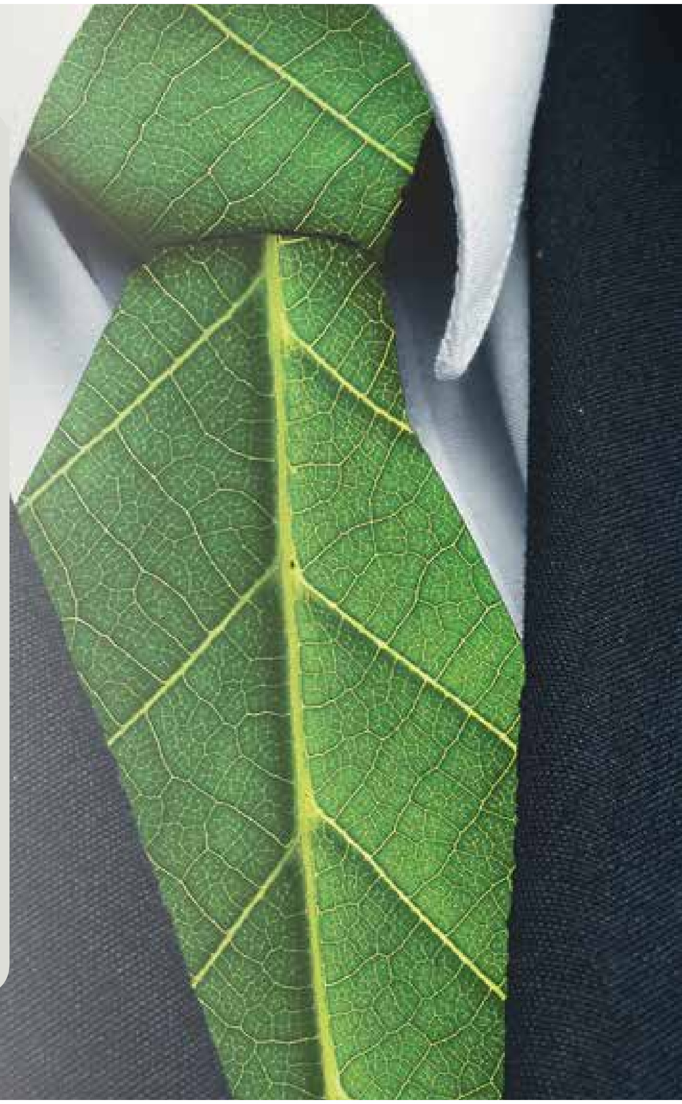
Saturna White Paper: Sustainability Series

The Sustainability Smile

An Advisor's Guide to Defining Sustainable Investing Strategies



In the context of investing, the term 'sustainability' lacks sharply defined boundaries. This broad label tends to create more confusion than clarity, prompting some advisors to simply skip it and move on. We suggest sustainability is worth a second look: institutional and private clients express interest with increasing frequency, and assets aligned to sustainable objectives are currently in excess of $59 trillion.[1]

To help you familiarize yourself with this growing segment, we provide 'The Sustainability Smile' – a visual tool that can help simplify and guide your conversations with current and prospective sustainability-minded clients by breaking down sustainable investing into digestible categories. Here you'll find an overview of what sustainability is, ways to incorporate sustainable investing into your client engagements, and, more importantly, how to identify the important cues that your clients may be interested in sustainable investing despite having difficulty articulating it.

Experience tells us that clients show far more certainty in knowing what they do not want than what they do want. If you are willing to familiarize yourself with this growing segment, you will find advantages to better position your practice in serving these clients' interests when and if the time comes.

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Why Sustainability?

Sustainable investing expertise adds value to your practice. It can help you better serve and retain existing clients who may decide their investments should better reflect their personal values. Broader knowledge of sustainable investing can differentiate your practice from your competitor's, helping you develop prospecting engagements. Additionally, these types of engagements may result in "stickier" and more substantial relationships because they include a "softer side" that shifts the advisory relationship away from a price-based, commoditization of your products and services toward a more customized, client-focused advisory practice model.

Please consider an investment's objectives, risks, charges, and expenses carefully before investing. To obtain this and other important information about the Saturna Sustainable Funds in a current prospectus or summary prospectus, please visit www.saturna.com/sustainable or call toll free 1-800-728-8762. Please read the prospectus or summary prospectus carefully before investing.

The Saturna Sustainable Funds are distributed by Saturna Brokerage Services, member FINRA / SIPC. Saturna Brokerage Services is a wholly-owned subsidiary of Saturna Capital Corporation, adviser to the Saturna Sustainable Funds.

Sustainability Overview

Sustainable and responsible investing has a rich history spanning over 250 years. Perhaps its earliest founding reference came from Pastor John Wesley whose 1758 sermon "The Use of Money" outlined the early tenets of social investing: Do not harm others through your business practices and avoid industries that can harm the health of others.[2]

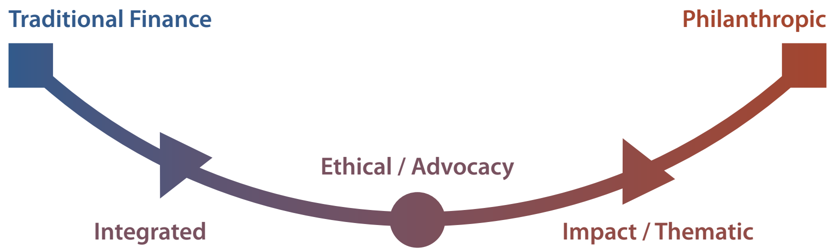
Social investing remained largely unchanged until the early 1980s, relying mainly on negative screening that seeks to exclude specific industries or companies, such as alcohol or tobacco, deemed inconsistent with the investor's value set. As socially responsible investing evolved, investors took on more of an advocacy role by proactively seeking companies engaged in better or preferred business practices. Propelling this shift, General Motors board member Reverend Leon Sullivan strongly supported the South African Apartheid Divestment Campaign.[3] Such investment considerations, known as positive screening, seek to identify investment opportunities based on comparative ESG and financial considerations relative to their peers.

The enormous amount of assets committed toward the integration of environmental, social, governance (ESG), and other social screenings demonstrates increasing traction with investors. Sovereign and pension funds are among the largest practitioners of sustainable and responsible strategies. When you consider that pension fund advisers manage to a multigenerational investment horizon, with debt issue maturities spanning multiple decades, the concern toward resource scarcity makes sense.

Today's sustainable and responsible investing exhibits greater robustness and familiarity among the investing public and institutions. As consumer preferences have trended toward healthy eating, healthier living, and a greater emphasis on community ties, so has the concept that investments can or should 'do good' as well. A recent Morgan Stanley survey titled "Sustainable Signals" found that 71% of individuals express interest in sustainable investing, and nearly two-thirds believe sustainable investing will continue to grow over the next five years.[4] A client who says "I want better companies" or "I am looking for companies that are doing some good" provides subtle cues of potential interest. Being prepared to discuss sustainable investing will help position your practice when that time comes.

The Sustainability Smile

The Sustainability Smile is a visual tool designed to help you discuss sustainable investing with your existing and prospective clients. It separates the broad and nebulous label of "sustainability" into five strategies with soft boundaries along a continuum from traditional finance to philanthropic investing. The Smile provides a framework to help you think about client engagements, potential investment strategies, and their respective product offerings. Please note that the positions of the differing strategies and general shape of the smile do not imply any specific investment outcome or predict any particular rate of return.



Traditional Finance

Traditional finance reflects current mainstream investment practices where no considerations regarding material ESG factors, negative screening, or positive screening take place. Investors in this camp focus solely on maximizing financial gain with little or no interest in broad stakeholder interests. These investors may comment that they would rather donate the gains. Milton Friedman best characterized this view when he stated that "there is one and only one social responsibility of business to use its resources and engage in activities designed to increase its profits so long as it stays in the rules of the game, which is to say, engages in open and free competition, without deception or fraud."[5] Such investors typically include hedge fund equity activists.

This investment process is relatively straightforward since it requires very few or no additional considerations.

Integrated Finance

Integrated finance can be best viewed as an evolutionary development of traditional finance. It combines a core emphasis on financial results with consideration of material ESG factors that may potentially impact financial performance or competitive advantage.

The somber episode of BP's Deepwater Horizon spilling oil unabated for over three months in the Gulf of Mexico offers the usual environmental example within recent memory. However, integrated finance extends beyond just mitigating potential risk to reflect a broader and more holistic view of what constitutes enterprise value. Investors in this camp tend to appreciate corporate management teams that offer transparency and specific strategies with respect to mitigating material ESG risk. Among some of the critical issues for telecom sectors and credit card vendors is a focus on data security. Industries highly dependent on supply chains, such as retail, manufacturing, and assembly, raise questions regarding the potential for foreign labor practices to negatively impact brand value. Water-intensive industries, such as utilities, semiconductor manufacturing, beverages, agriculture, and resource extraction, gain considerable attention in the face of increasing droughts. Industries highly dependent upon large fuel consumption, such as firms with large vehicle or airline fleets, contend with emissions regulations and gain advantages through alternative fuel sources.

Within each industry there is usually a thought leader – a best-in-class exemplar – followed by the middle of the pack, and closing out with a worst offender, sometimes referred to as the bad actor. Integrated finance, also known as responsible investing, aims to identify firms that proactively address key material ESG risks within their respective sectors, potentially forming a competitive edge relative to their peers. It is interesting to note that given the extended drought conditions facing California many publicly traded semiconductor firms whose operations reside in the state are silent with regard to their water usage and consumption strategies.

Academic studies broadly support that integrated finance tends to reduce cost of capital, implying an increase in value for firms that exhibit transparency related to material ESG factors and employ strategies to address these risks.[6]

Ethical / Advocacy

Ethical investing, sometimes referred to as faith-based investing, seeks to build portfolios that reflect the value set of an investor's religious denomination. Typically, such engagements exclude or avoid ownership in specific industries, such as alcohol, tobacco, or gambling. These engagements tend to be rather straightforward and distinct from integrated investing in that the primary objective is to employ negative screens.

Advocacy investing takes a different tack. It seeks to bring about shareholder engagement through the ownership of a company's stock and active participation in shareholder proxies aimed to bring about specific, measured change. Advocacy may encompass any number of possible issues to include governance-related, environmental, and social change. More recently, the advocacy movement gained new momentum through the Carbon Divestment Campaign, which challenges large carbon-based asset companies, such as ExxonMobil, to dramatically transition their business practices toward more "green" energy sources.

While outside of the scope of this article, we should recognize the importance of returns because ultimately we are talking about investments. The ethical/advocacy category emphasizes a permissible investment universe through the lens of exclusionary screening, or inclusionary consideration based on issue advocacy, which often coincides with a willingness to forgo *maximum* investment returns in order to reflect specific values or advocacy views. While returns do matter, there remains a certain level of 'return forgiveness' in these measured approaches. Remember that the Sustainability Smile represents the entire investing continuum, and each strategy comes with its own priorities, restrictions, and return expectations.

Thematic/Impact Investing

Thematic investing tends to reflect sector-specific industries, such as clean energy, while impact investing tends to allocate capital toward enterprises that can achieve measured results among the three Ps: people, planet, and profit. Green bonds, for example, would qualify as being more thematic since the debt issuers' proceeds are allocated toward climate change mitigation projects. These can include funding of energy efficiencies, including LEED certified[7] buildings, or clean energy. Thematic investing has gained broader appeal, and such investment strategies are provided through mutual funds and a few select hedge fund managers.

Impact investing is a category in itself and not bound by any specific theme. It aims to generate competitive, risk-adjusted returns based on the underlying characteristics of its asset class, whether land, real estate, debt, or equity, while demonstrating specific, measurable results with regard to a social and/or environmental agenda. Impact investing is also gaining broader investor appeal although access may be limited to accredited investor fund vehicles and a few mutual funds.

Philanthropic

Philanthropic investors fall on the opposite end of the spectrum from traditional finance, which tends to subscribe to the notion that material ESG factors have little influence on performance return metrics yet engages in a process of profit maximizing behaviors. Philanthropists focus entirely on maximizing the impact of their value sets with little, if any, regard for investment returns. This categorical group aims to leverage their investments to achieve charitable results or to structure their investments to create financial distributions that align with their value sets. Such investments may include program-related investments (PRI) that offer a minimum (or sometimes zero) return if they can further enhance the potential impact of an investor's preferred philanthropic passion.

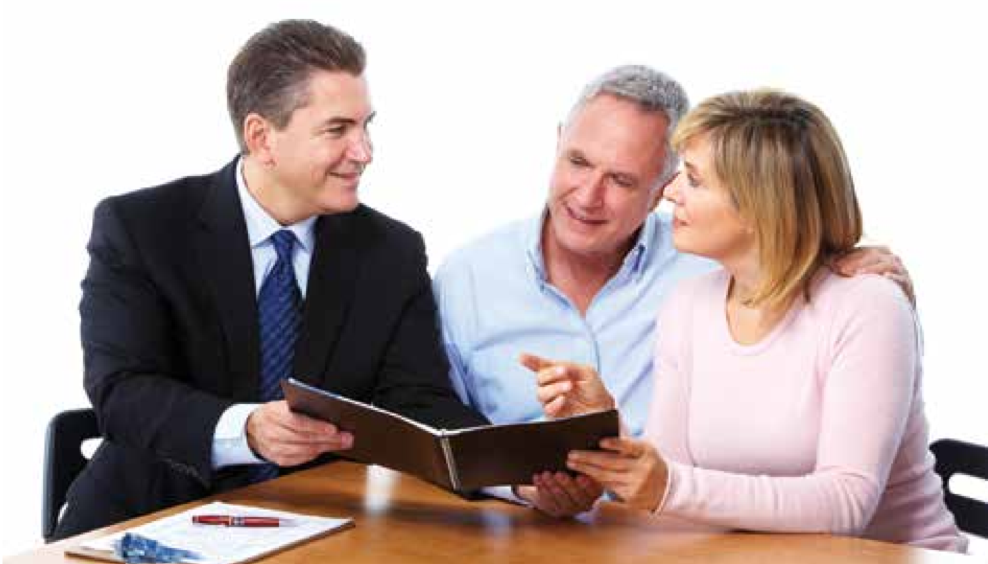
Having The Conversation

The Sustainability Smile casts a broad net on how to think about the type of conversation you may have with an existing or prospective client. Because the definition or interpretation of sustainable investing will often differ from client to client, we recommend that the conversation not begin with "Do you want sustainable funds?" An engagement with a religious or faith-based organization would mostly likely proceed quite differently than a conversation with environmental organization. While there may be crossover interests, the end result should be tailored to reflect the client's individual value set.

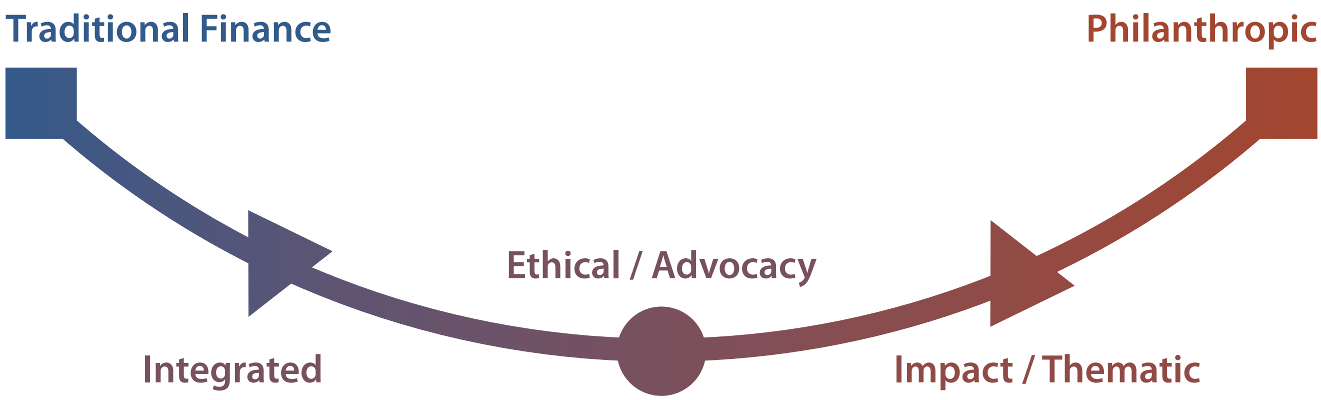
Very rare are the clients that can articulate their social value profiles sufficiently enough to design investment portfolios around them. More often, we find that clients are unaware their preferences fall along the socially responsible spectrum. These cases require expert listening skills on your part, and the ability to recognize subtle clues.

At times these engagements fall into one's proverbial lap. At others times they must be teased out through clarifying questions. If a client specifically inquires about sustainable investing, you can use the Sustainable Smile as a tool to discover what that means. Other clients provide only subtle clues. At this point, ask open-ended questions that may help you navigate along the Smile spectrum. Is the client's focus more faith-based or is it more thematic? Is the client trying to articulate a desire to own companies that are more conscientious in the way they conduct their business? If the latter, suggest integrated, ESG investing through a process of avoiding the worst offenders while simultaneously seeking firms that position themselves as best in class.

Even more subtle cues may come in the form of statements such as "I want better/good companies" or "Is there a way to not own/avoid owning" such and such. Another favorite is "Can we do better?" which, in the context of the client's consumer preferences and/or lifestyle, may not pertain to investment performance but rather portfolio holdings and fund sector allocation. These little gems offer fantastic opportunities to ask one clarifying question, "What do you mean when you say…?" and then let your client do the talking. If the client isn't yet ready to move forward, simply add that when and if the time comes, you will be more than delighted to revisit the conversation and align their portfolio accordingly.



The Sustainability Smile



About Saturna Capital

Founded in 1989, our broad experience distinguishes Saturna in the investment business. Each of our employees is committed to creating and maintaining a unique firm, where client interests always come first.

We are a premier international, independent investment firm based on seven Core Values:

- Top-quality professionalism
- Uncompromising loyalty to clients
- Risk management
- Integrated business operations
- Investor education
- Prudent entrepreneurship
- Community contribution

Our main office in Bellingham, WA is between the Pacific Northwest's major cities (Seattle and Vancouver, BC). Employees in the Northeast, Southwest, Midwest help us service clients across the US.

In addition to its primary business of giving investment advice, Saturna Capital (1) owns Saturna Sendirian Berhad, an investment adviser and research firm in Kuala Lumpur, Malaysia; (2) owns Saturna Brokerage Services, Inc., a general securities broker-dealer; (3) owns Saturna Trust Company in Henderson, NV, a trust services company; (4) owns Saturna Environmental Corporation, owner of a 133-acre environmental center; (5) provides administration services, including fund accounting, to its affiliated mutual funds; and (6) develops investment administration software (NEPTUNE©).

Saturna Trust Company provides a number of tax-advantaged and retirement plans, including IRA, HSA, ESA, SEP, and SIMPLE plans. Saturna Capital also provides recordkeeping and administration services to 401(k) plans.

Saturna is named for one of the larger islands in northern Puget Sound's beautiful and well-known San Juan archipelago, easily visible from Bellingham. Sparsely settled, most of Saturna Island is part of Canada's Gulf Islands National Park.

About The Author

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Patrick T. Drum, Research Analyst and Portfolio Manager, joined Saturna Capital in October 2014. He is also a portfolio manager for the firm's institutional subsidiary, Saturna Sdn Bhd in Kuala Lumpur Malaysia, directing *halal* fixed income investments.

He is a select member of the United Nation's Principles for Investment (UNPRI) Fixed Income Outreach Subcommittee and an adjunct professor of finance at Pinchot University, formerly known as Bainbridge Graduate Institute (BGI). Mr. Drum has nearly ten years of experience integrating ESG considerations into fixed income portfolio management.

He holds a BA in economics from Western Washington University and an MBA from Seattle University Albers School of Business. He is a Chartered Financial Analyst Charterholder (CFA) and a Certified Financial Planner®. Mr. Drum has nearly twenty years of investment experience in serving institutions and private clients.

Footnotes

[1] *Principles for Responsible Investment website, What's New, June 2, 2015. http://www.unpri.org/whatsnew/signatory-base-aum-hits-59-trillion/*

[2] *Wesley, John. Wesley Center Online, Sermon 50, The Use of Money. http://wesley.nnu.edu/john-wesley/the-sermons-of-john-wesley-1872-edition/sermon-50-the-use-of-money/*

[3] *The Sullivan Principles. http://www.marshall.edu/revleonsullivan/principles.htm*

[4] *Morgan Stanley Survey Finds Sustainable Investing Poised for Growth, February 27, 2015. http://www.morganstanley.com/about-us-articles/06490ef0-a8b2-4a68-8864-64261a4decd0.html*

[5] *Friedman, Milton. The Social Responsibility of Business Is to Increase Its Profits. New York Times Magazine, September 13, 1970.*

[6] *Clark, G., Feiner, A., and Viehs, M. From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance. March 2015. https://yoursri.com/news/arabesque-partners-and-oxford-university-update-sustainability-meta-study*

[7] *Leadership in Energy & Environmental Design (LEED) is a green building certification program that recognizes best-in-class building strategies and practices.*

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