AGF INVESTMENTS
AGF MARKET INSIGHT
What are you doing after work?
SEPTEMBER 25, 2015

Volkswagen – why this matters

Remember the cyclist who seemed to do the impossible – beating the world's best athletes by significant margins despite facing seemingly insurmountable physical odds? All the world wanted to believe in this athlete and his story, despite logic dictating a closer look.

More recently, an underperforming car company, in a feat of tremendous engineering innovation, launched a series of vehicles that could apparently provide it all – decent pricing, excellent fuel economy and reduced emissions. With consumers loving it, this innovation formed the basis for the company's strategy going forward.

We know how these stories end…in both cases:

- The great majority of people simply accepted the story at face value
- A small minority with technical expertise found ample concern for disbelief
- The protagonist vehemently denied any wrong-doing and knowingly mislead regulators
- The process stretched over many years, but the end was devastating to many seemingly far removed
- A relative morality is applied – 'it's not like they were the only ones doing it' or 'it's not like anyone died' (well at least directly) or 'this is a drop in the bucket'

ISSUES FOR INVESTORS TO CONSIDER

1. **Trade-offs for reducing environmental footprints.** European regulators' love affair with diesel stems from the technology's ability to produce less carbon emissions and have better fuel economy than gasoline engines. The trade-off is higher emissions of nitrous oxides (NO_x) which, due to poor air quality, cause more serious short-term environmental and health

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impacts. Scientists were aware that increasingly declining air quality in major European cities was linked to greater penetration of (non-compliant?) diesel vehicles. To make useful capital allocation decisions, our focus on carbon needs to be balanced with the realities of environmental science.

2. **Environmental issues material to short-term and long-term market value.** VW lost more than 35% of its market cap in two days after the story broke. Other manufacturers and industry suppliers also suffered substantial losses.
3. **Sustainability critical to success in many industries.** These are not side-show factors with little real economic impact. The efforts to meet tighter regulations are driving capital investment and strategy.
4. **Other companies may also be fabricating environmental data** in order to maintain their 'green credentials.' Beyond just the reporting deficiencies, audit trails for this data can be inadequate. The tendency of the financial industry to aggregate numerical scores to summarize a company's performance in an easily digestible format is not helpful in this regard.
5. **Do emerging clean technologies deserve lower hurdle rates** in financial models given that they will be needed to make serious progress on emissions? This would attract more capital and improve their economics over conventional but challenged technologies such as diesel.

A REAR-VIEW MIRROR LOOK AT VW'S ESG SCORES

By all accounts, VW scored highly by ESG research providers for environmental performance. The company is a member of several prominent **ESG benchmarks and was accorded reasonable rankings relative to its industry peer. Questions that arise:

- Why were emissions of NO_x not given higher (or any) weighting in the company scoring?
- Do sustainability research providers have the expertise to assess the intricacies of company technologies?
- What is the value-add of the sustainability research relative to the mainstream?

Within the mainstream, some very detailed analysis supports the view that diesel vehicles are in secular decline. This analysis has recognized the trade-off between CO2 and NO_x for diesel engines and explained the various control technologies. Lacking was any assessment of materiality prior to the issue's disclosure. In other words, while analysts recognized the technical challenges, there was no insight into whether they could be achieved using VW's flagship technology. Specifically, the discrepancies between real world vs. simulated driving performance has been known for some time; however, its materiality as an investment issue never surfaced. This is somewhat different from sectors such as mining where the feasibility of an important mine is likely assessed by a technical specialist prior to the company receiving a buy rating.

LOOKING FORWARD

Our focus has primarily been amongst suppliers of emissions control equipment and manufacturers with significant exposure to emissions-free vehicles (VW did not meet this threshold). Needless to say, we expect continued volatility in the auto sector as events unfold and will redouble our efforts to assess the technical merits of perceived 'sustainability solutions' as we allocate capital.

For more information on AGF Global Sustainable Growth Equity Fund, including its environmental footprint, please visit AGF.com/SustainableInvesting or contact your Financial Advisor.

* AGF Clean Environment Equity Fund was renamed AGF Global Sustainable Growth Equity Fund on May 20, 2015.
AGF Investments Inc. replaced Acuity Investment Management Inc. as portfolio manager, effective April 17, 2015. On August 7, 2007, the Fund changed its investment objective to permit greater foreign-property investments.
**Volkswagen's Ratings and Indexes are available at:
http://sustainabilityreport2014.volkswagenag.com/background/ratings-and-indexes

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