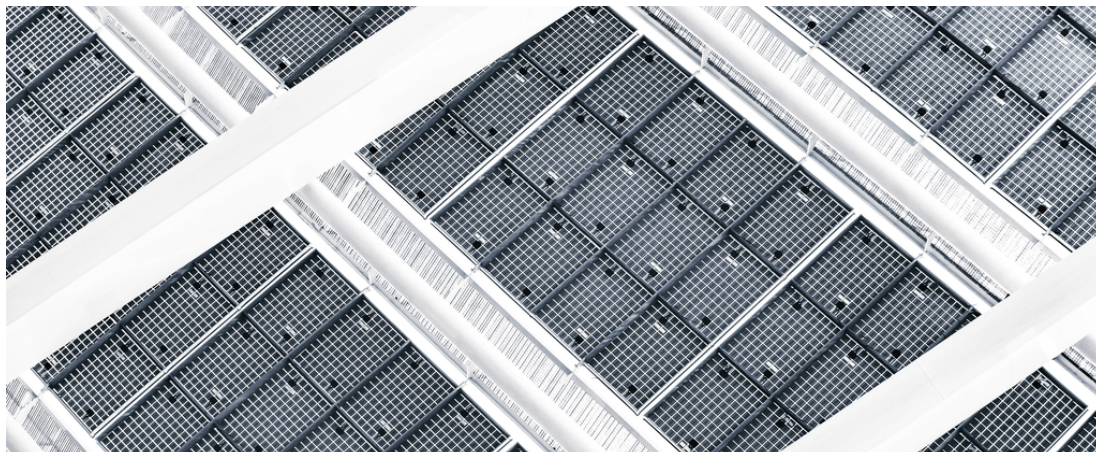


SI Approach

The UBS approach to **sustainable investing**



Executive summary

Sustainable investing is changing the way investors think about the companies they invest in. In this chapter we examine the new insights that can come from integrating material, non-financial data in the investment analysis process. We chart the rise of sustainable investing, the push and pull factors and the exciting innovations which sustainable investing is bringing to the investment industry:

- The past five years have seen sustainable investing move mainstream, fueled not just by growing client demand but also by growing regulatory pressures.
- Additionally, external actors such as the UN backed Principles for Responsible Investment have been instrumental in driving the move towards greater investment transparency.
- At the same time, the United Nations SDGs, while broad and overarching, have provided a benchmark along which to align investment decisions to create impact.
- To meet this upsurge in demand, UBS Asset Management have developed a detailed, comprehensive approach to sustainable investing, based on two key pillars: the integration of ESG factors in the investment research process and an active engagement policy.
- The new approaches to sustainable investing which UBS is pioneering also aim to generate an innovative, flexible approach to creating positive impact.

Sustainable investing has widely been recognized as the fastest-growing segment in the investment world. Between 2012 and 2016, sustainable assets under management almost doubled, from USD 14 trillion to USD 23 trillion, according to a 2016 report by the Global Sustainable Investment Alliance.

The broadening use of material, non-financial data in the investment analysis process, most often as the inclusion of ESG – or environmental, social and governance – metrics, has helped investors take a broader view of their investments. The integration of this material sustainability criteria has led to better-informed investment decisions through the identification of growth opportunities and the

management of long-term risks. Research already indicates that investing according to ESG metrics does not materially harm returns and can instead strengthen portfolios by lowering the cost of capital and mitigating risk¹.

This new transparency, achieved through ESG metrics, gives investors material, often quantitative, insights into how well businesses are run, where their real risks lie, and how sustainable their business models and practices really are. Companies that care about sustainable use of resources will be less exposed to shortages. Companies with superior labor practices will have more productive workforces and be less prone to labor strife. Companies that follow governance best practice will likely be better and more sustainably managed and less prone to corruption. The list goes on. Additionally, customers of these companies also get information – both positive and negative – of the kind that ESG tracks, which could impact buying patterns and consequently corporate performance over time.

Sustainability data thus has the power to completely change the way investors think about the companies they are investing in, enabling more credible, forward-looking investment decisions. It is therefore not surprising that institutional investors consistently rank ESG criteria as one of their top issues when choosing an asset manager.

A global call for sustainability

The increasing focus on sustainable investing (SI) has been partially fueled by growing client demand. SI has been a trend with retail investors for over a decade, but it is only in the last five years that SI has moved into the mainstream arena with institutional investors seeking to engage with assets that score high on ESG metrics and have positive impact on the ground.

The inherent value and impact that non-financial material data can have on risk management and performance has resulted in the accelerated reporting of ESG factors. Research shows that 78% of asset owners consider ESG management to be one of the top five issues when choosing an asset manager², clearly demonstrating the extent to which mainstreaming of ESG has evolved in recent years. The demand for SI is clear, with 85% of asset owners reviewing a manager's responsible investing policy, and over 60% assessing ESG incorporation strategies, and the ability to identify and manage ESG issues³.

In July 2017, Japan's Government Pension Investment Fund, the world's largest pension fund, announced that it was increasing its allocation to sustainable investments, giving SI an impressive vote of confidence and a commitment that many asset owners are likely to follow.

External actors

The global shift towards sustainable investing has been hastened by a series of push and pull factors from different stakeholders that have increasingly come to demand greater transparency and disclosure, leaving less room for asset managers and companies unwilling to comply. For example, the pressure to take action was spurred onward by the signatories of the UN Paris Pledge for Action in 2015.

The impact of the global trend towards sustainability on the investment community is reflected by the UN Principles for Responsible Investment, whose signatories voluntarily choose to show their commitment to incorporating ESG issues into investment practice. Launched in 2006, today over 1,500 institutions across 50 countries are signatories, representing USD 62 trillion in invested assets⁴, indicating a consensus on the importance of sustainable investing.

Another such global mandate is The Climate Risk Task Force of the Financial Sustainability Board that has published a set of recommendations for investors, lenders and insurance underwriters for better disclosure and understanding of material risks⁵. Bodies such as the Global Impact Investing Network

1 One of the more recent studies of the correlation of corporate financial performance and sustainability performance found that "firms with good performance on material sustainability issues significantly outperform firms with poor performance on these issues, suggesting that investments in sustainability issues are shareholder-value enhancing." Dunn, Jeff, Fitzgibbons, Shaun, and Pomorski, Lukasz. "Assessing Risk Through Environmental, Social and Governance Exposures." 2017. This paper discusses the risk and return implications of incorporating ESG considerations into investment strategy, focusing on the risk side in particular. Its conclusion: "Stocks with the worst ESG exposures have total and stock-specific volatility that is up to 10–15% higher, and betas up to 3% higher, than stocks with the best ESG exposures."

2 Responsible Investor, Asset Owner Survey 2015.

3 Principles of Responsible Investment, PRI Report on Progress 2015.

4 Principles of Responsible Investment, PRI Report on Progress 2015.

5 <https://www.fsb-tcfd.org/publications/fnal-recommendations-report/>.

(GIIN) have also lent their voice and support to the issue, launching a campaign in September 2016 that called for investors to direct more capital to the Sustainable Development Goals (SDGs).

Amongst the largest global calls to action have been the United Nations SDGs. Though broad and overarching, they provide a benchmark along which to align investment decisions to create impact. One example of their influence is a Dutch institutional investor who has explicitly committed over EUR 2.2 billion to an investment framework based on the SDGs, with a focus on climate, food, health and water⁶. This commitment went beyond investment choices, striving to create both financial and social returns by investing in companies creating measurable impact.

The actions of these external actors have effectively served to increase awareness for all stakeholders, increasing the pressure to accelerate ESG integration. This has not been restricted to global governance bodies. In companies too, there is a push by regulators for greater openness around ESG matters. Thirty-eight stock exchanges around the world have provided ESG reporting guidance to issuers and 15 actually require ESG reporting as a listing rule for certain companies.

Moreover, it is likely that this trend is here to stay. Several indicators have asserted that sustainability will remain high on the agenda in the future. Take the Campden study for example, which found that 69% of UHNW Millennials say they are interested, or very interested, in socially responsible investing⁷.

SI integration across asset management portfolios

Cumulatively, all these developments have led to a significant global shift of assets into sustainable investments. Yet, while sustainable investing has catapulted into center stage globally, it is a relatively recent trend. UBS has a strong legacy of investing sustainably for over 20 years. As far back as 1992, UBS was amongst the earliest signatories of the UNEP bank declaration (UNEP FI), going on to become a member of the Association for Environmental Management and Sustainability in Financial Institutions in 1996. The UBS strategy for sustainability was launched in 1997, prophesizing the shift in global consciousness. Today, the financial markets are one of the most powerful transmission mechanisms by which corporate sustainability can be promoted globally, thereby impacting society in a positive way.

Putting that conviction into practice, UBS has already made a clear commitment to integrating ESG considerations into core investment processes across the firm, with the aim of having full SI integration across equity and fixed income research platforms by the end of 2018. This will enable all 900+ investment staff to take SI factors into consideration, making UBS the first large-scale asset manager to implement broad integration of SI across the traditional asset classes. This outlook has resulted in UBS becoming the largest provider of SI equities and fixed income ETFs in Europe.

Developing an investment strategy

At UBS, developing a sophisticated sustainable investment strategy has been a detailed process involving several key factors, to ensure high impact on the ground without compromising on fiduciary responsibilities. The approach rests on two key pillars: the integration of ESG factors in the investment research process and an active engagement policy.

Integrating SI capabilities across asset classes relies on a process of close collaboration. A dedicated SI research team works with the equity and fixed income analysts, helping them identify material ESG factors by looking deeper at which particular aspects of an issue are relevant for a specific sector. For instance, human capital can be looked at from the perspective of working rights and conditions, occupational health & safety, and culture. The importance of these different topics varies in terms of their effect on creditworthiness depending on the activities in a sector. Working rights and conditions may be more important to productivity in a manufacturing sector; occupational health & safety may be important to operational effectiveness in oil & gas production, whereas culture may be more relevant to ethical sales in an insurance company or a bank. Such analysis is then captured both in an overall score and a direction, which is then applied within the overall equity or credit analysis.

We firmly believe that one of the key drivers to moving more assets into sustainable strategies is the integration of sustainability in fundamental research, impacting all actively managed strategies. This is why it is essential that the analysts sit at the heart of the investment process.

⁶ Dutch SDG Investing (SDGI) Agenda.

⁷ Campden 2015 UHNW Millennials Research report.

UBS are firmly of the view that it is mainstream analysts who are best placed to make use of existing knowledge and experience to provide the context in which to consider sustainability issues. Analysts aggregate both quantitative and qualitative data, consider its relevance and materiality, put it into an appropriate recommendation framework, and then also make judgements based on sometimes incomplete and imperfect information. Analyzing ESG issues requires the same skills, albeit from a different starting point, a different set of conditions and with divergent conclusions. It is these forward-looking judgements which distinguish the work of the analyst from pure ESG data gathering or scoring.

In tandem with this mainstreaming of ESG factors within research is the adoption of a policy of active engagement: exercising shareholder rights by proxy voting and corporate engagement, and proactively reaching out to companies to discuss material ESG issues. UBS has a dedicated stewardship team that works closely with SI analysts and investment teams to understand company strategies and performance on sustainability issues, and select cases for engagement. In opening channels of conversation with companies, it is possible to engage in constructive dialogue, developing and executing 1–3 year engagement programs tailored to specific companies. By actively participating in voting, it is possible to influence strategic outcomes, ensuring greater impact and better-informed investment decisions. It is this dual force of integration and engagement that ultimately affects impact.

There is, of course, an additional aspect to the concept of impact and that is measurement – how can the impact of an investment on society and the environment be measured? To address this, UBS has set up research partnerships with leading universities to develop a proprietary set of impact measurement metrics. The ESG assessment methodology at UBS has also evolved over time to reflect the goals of the SDGs and assess the impact which companies, through their supply chains, direct operations and services and products offered, are making towards those goals.

An account of the investment approach would not be complete without considering the roles of more conventional, data-driven approaches, such as screening. Simply screening out companies that do not meet environmental, social or ethical criteria has been perceived as problematic, as critics believe this could conflict with the fiduciary responsibility of asset managers. Hence the preferred approach of UBS places an emphasis on positive screening, a process that focuses on investments with strong ESG characteristics in combination with attractive financial fundamentals. Positive screening allows investors to establish a systematic approach towards identifying companies that demonstrate high quality management, and the ability to mitigate various sustainability risks.

Innovation is essential

The new approaches to sustainable investing which UBS is pioneering aim to create an innovative, flexible approach to creating positive impact. Addressing concerns in the investment community that sustainable investment limits choice and compromises a client's primary financial objectives, UBS has developed several innovative, tailor-made solutions to address specific investor challenges.

A large pension fund needed a passive carbon-aware product that aimed to replicate benchmark returns while increasing relative exposure to companies adapting to a lower-carbon future. To address this requirement, UBS developed a Carbon Aware Rules-based Global Equity strategy, a proprietary framework to create a composite score for companies based on current and historical carbon data (including data uncertainties), probable carbon reduction path and forward-looking variables that gauge company commitment to and engagement with emission reduction initiatives. The framework takes into account the carbon glide path required of each of the selected index's industry sectors and companies that either need to reduce carbon intensity or are carbon neutral, such as renewable energy.

Rather than simply reducing exposure to companies with higher CO₂ emissions, the team at UBS also examined the trajectory of emissions reduction over time. By examining the commitment of the company management towards emissions reduction, it was possible to orient the portfolio towards companies better prepared for a low carbon future and mitigation of global warming as outlined in the United Nations Paris Agreement. Moreover, the UBS strategy focuses on reducing the exposure to, rather than excluding, companies with higher carbon risk, in order to minimize risks by not excluding significant parts of the market.

As at December 31, 2017 the Fund's low carbon credentials were as follows:

- Total CO₂ emissions by portfolio companies were contracting at an annual rate of 1.3%, compared to a rate of decline of 0.4% in the benchmark index.
- Scope 1 CO₂ emissions were 27% less than the benchmark index.
- Coal energy consumption was 47% less than the benchmark index.
- The CO₂ that could potentially be emitted from reserves of fossil fuels was 31% less than the benchmark index.
- The Fund's investments in renewable energy sources was 59% higher than the benchmark index.

UBS Asset Management's approach differs from the standard investment community approach of overweighting stocks of companies that are less dependent on fossil fuel, based primarily on historical or current carbon data. This is especially significant as the traditional approach does not take into account the forward-looking aspirations of the global community under the Paris Accord. Additionally, UBS Asset Management has taken a unique approach to systematically integrating ESG factors within its fixed income research process. Increasing levels of corporate disclosure, as well as the expansion of corresponding coverage by ESG data providers, create a sound basis for integrating ESG into fixed income strategies. There have also been several important innovations in the fixed income space, including the rise of green and social bonds.

Integrating ESG into credit research makes the most of significant opportunities to pursue sustainability integration at a much deeper level than has been previously considered. The next phase of development is to integrate sustainability into standard credit assessments, which could have significant implications for mainstream investors looking for opportunities to apply sustainability to their core credit portfolios⁸.

The broad integration of sustainable investing at scale is something new within the asset management industry. But the transparency that process creates is crucial. It aligns with one of the most important and pervasive societal trends of our age – the trend towards ever more information, ever more data, ever more transparency everywhere. For investors, the new metrics that SI brings give investors material, often quantitative, insights into how well a business is run, where its real risks lie, and how sustainable its business model and practices really are. If fully embedded in the investment decision-making process, these metrics can be powerful techniques. By bringing sustainable investing to the next level, UBS believes it can play a leadership role in integrating sustainability considerations into mainstream finance.

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⁸ Many of these developments were highlighted in a recent publication outlining these rapid developments in ESG investing in fixed income. See The World Bank, "Incorporating Environmental, Social, and Governance (ESG) Factors Into Fixed Income Investments," April 2018. <http://www.worldbank.org/en/news/feature/2018/04/19/incorporating-environment-social-and-governance-esg-factors-into-fixed-income-investment>.

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