Long-term value creation

Sustainable investing for Institutional Investors

Michael Baldinger, Christopher Greenwald
Historically, a major challenge for larger asset owners interested in sustainable investment strategies has been that many sustainability-focused providers have tended to be smaller boutique asset managers. This is changing. Mainstream global asset managers are starting to develop new and innovative solutions to meet the sustainable investing needs of their clients. While this represents a significant development, it also requires a new understanding of the nature and goals of sustainable investing, one which is better suited to client needs.

This paper offers an examination of the ways in which larger investors can successfully approach sustainable investing. It sets out a framework and suggests various strategies that are needed to drive sustainability in such a way that it meets the needs of those larger institutions that may not have previously incorporated sustainable investing within their overall investment approach.

Our starting point is an assessment of the limitations of previous approaches to sustainable investing, typically through negative and positive screening. We propose an alternative approach for mainstream investors – understanding sustainability in terms of long-term investing.

Research shows clear investor expectations

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<tr>
<th>CalPERS</th>
<th>69%</th>
<th>$62tn</th>
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<tbody>
<tr>
<td>will require all of its managers to identify and articulate ESG in their investment processes</td>
<td>UHNW Millennials interested or very interested in Socially Responsible Investing</td>
<td>AuM managed by signatories to the Principles for Responsible Investment</td>
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<table>
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<th>€2.2tn</th>
<th>78%</th>
<th>85%</th>
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<tbody>
<tr>
<td>Dutch Financial Institutions made an explicit commitment to use the UN Sustainable Development Goals (SDGs) framework</td>
<td>of asset owners surveyed consider ESG management to be one of the top 5 issues when choosing an asset manager</td>
<td>of asset owners review a manager’s RI policy, and over 60% assess ESG incorporation strategies and ability to identify and manage ESG issues</td>
</tr>
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</table>

$10tn
120 investors with over $10tn have signed the Montréal Carbon Pledge

1 www.montrealpledge.org
2 Top 1000 Funds, May 2015
3 Campden 2015 UHNW Millennials Research report
4 PRI Annual report 2016
5 Dutch SDG Investing (SDGI) Agenda
6 Responsible Investor, Asset Owner Survey 2015
7 Principles of Responsible Investment, PRI Report on Progress 2015

Sustainable Investing has grown rapidly over the past 10 years. However, its emergence as a key topic among larger investors has been relatively recent.
Screening approaches to Sustainable Investment

Despite impressive growth rates, sustainable investing has faced difficulties in entering mainstream investment strategies. This is only just starting to change. In part this has been due to investors’ misperceptions – a belief that sustainable investment limits choice and compromises a client’s primary financial objectives. This view arose from more traditional sustainable investment strategies that used a combination of negative and positive screens in order to select companies for an investable universe.

Negative screening of funds has been pursued by faith investors since the 19th century, but it was not until the 1980s and the emergence of ‘SRI’ investing as a means of divesting from companies involved in supporting apartheid in South Africa that it gained widespread attention. While negative screening provided an initial strategy for early socially responsible investment funds, we do not believe it provides a sound basis for moving sustainable investment into the mainstream.

First, negative screening criteria usually reflect the ethical requirements of particular clients; there is not normally a common set of ethical standards across all clients that can serve as the basis for a broader approach for mainstream integration.

Second, avoiding companies engaged in certain practices fails to impact the companies themselves – it may even encourage unsustainable practices by transferring ownership to those who are unconcerned about sustainability.

Third and most importantly, excluding sectors or stocks on ethical grounds provides no financial benefit to the investment strategy. On the contrary, it could harm long-term returns by limiting investment options.

Negative screening perpetuates the belief that sustainable investing restricts choice based on ethical principles. It is therefore important to move beyond negative screening to establish a firmer foundation for mainstream investment strategies.

In response not just to these issues, but also to the rapid growth in corporate sustainability disclosure, a focus on positive screening using Environmental, Social, and Governance (ESG) emerged in the 2000s.

Positive ESG screening had the advantage of being additive to the investment process. It allowed investors to establish a systematic approach to identifying those companies which demonstrated high quality management and it had the ability to mitigate various sustainability risks. Over the past decade, positive screening has also provided the basis for a significant growth in “best in class” sustainability funds and Indices.

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1 For more on this common perception of sustainable investment as hindering mainstream adoption, see OECD, “Investment governance and the integration of environmental, social and governance factors” (2006), p. 12. www.oecd.org/cgfi/resources
2 For an overview of the growth in positive screening funds, see the latest survey of the SRI market by the European Social Investment Forum, www.eurosif.org/sri-study-2016

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While positive ESG screening has been an important step forward in the evolution of sustainable investment, in isolation it is insufficient as an approach for larger investors. There are several reasons for this.

First, the reported ESG data used for positive screening is based on risk management performance metrics. However, it generally lacks the information needed to address the positive external impacts of companies’ products and services. These represent not just a company’s most important sustainability impacts, they also drive a company’s financial success through sales growth over the long-term.

Second, although most academic research has demonstrated that the integration ESG information does not harm returns and may provide a mitigation of downside risks, the perception remains among many asset owners that sustainable investment strategies could compromise performance and therefore be inconsistent with fiduciary duty. This perception largely stems from the view of ESG as a screening process which limits investment options, rather than a means of providing additional, value-adding insights into the long-term risks and opportunities of companies.3

Finally and perhaps most fundamentally, the approach of ESG screening has remained a step independent of financial analysis and research and therefore distinct from the traditional investment process. This is evidenced by the fact that most ESG ratings and research are conducted by third parties who do not make active investment decisions. For sustainability to truly enter the mainstream, it will need to be adequately included in the financial models and recommendations used by mainstream asset managers. Rather than incorporating sustainability into selected strategies through positive screening, large asset managers should enhance their overall methods of valuing companies based on the unique insights that ESG data provides. Such a transition requires a new understanding of the foundation of sustainable investing that is aligned to the long-term investment requirements of institutional clients.

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Sustainable investment and long-term investing

The case for asset managers to integrate sustainability in their offerings ultimately rests on one question: to what extent can clear benefits for clients be identified?

To answer that question, we would argue that firstly investors need to re-calibrate the way in which they view the investment process. We believe a better lens through which the large scale institutional investor should view the investment process is that of long-termism, or long term investing.

In our view, such an approach provides a much broader base for understanding sustainable investing, one which is more closely aligned to the natural time frame by which investors formulate their strategies and one which is additive to the overall investment process. Sustainable investing is not about screening away opportunities and limiting choices; on the contrary, it is about finding new opportunities by identifying long-term sustainability trends and accounting for longer-term risks.

The concept of ‘Long-term’ investing as an approach which can also serve as a firmer foundation for more mainstream sustainable investment strategies has been actively promoted by a number of leading investors in recent years. McKinsey and the Canadian Pension Plan Investment Board have been key proponents; in 2013 they established the “Focusing Capital on the Long Term” (FCLT) initiative to help overcome the financial market’s focus on short term performance.

The FCLT arose from a recognition that many asset managers do not adequately address the obligations of larger investors’ to manage longer-term risks and invest in those companies best positioned for long-term success. The FCLT has recommended that investors should give clearer, more concrete incentives to orient their strategies around long-term drivers of success. This should, in turn, incentivize companies to give a clearer articulation of their long-term strategies in public reporting.

In 2015, the FCLT published the “Long-term portfolio guide”. This document provides a series of recommendations to asset owners for developing more long-term investment strategies, including the use of longer-term incentives for asset managers and the development of alternative benchmarks to market cap weighted indices.

The FCLT’s framework also serves as a useful basis for developing an approach to sustainable investing – one that better enables mainstream managers to serve their clients. Sustainability issues – from climate change, to increasing inequality, to energy efficiency – impact company performance and risk over a longer-term time frame. Strategies which explicitly integrate these issues are particularly appropriate for larger investors, given their similarly long-term investment horizon.

Understanding sustainable investment in terms of long-term investing can offer a framework within which strategies and approaches can be developed that are consistent with the longer-term fiduciary obligations of those investors.

As well as providing a clearer basis for understanding sustainable investment, the concept of long-term investing has implications for how mainstream asset managers can integrate sustainability into their strategies.

Specifically, we believe the following approaches offer larger asset managers the most important means for developing long-term investment strategies which have the potential to mainstream sustainable investing.

- Integration of ESG factors into mainstream investment research
- Strengthening trust with clients through an innovative, solutions driven approach tailored to meet the clients’ specific requirements
- Pursuing strategic engagement with companies on sustainability issues that lead to material improvements
- Transforming the question of how out-performance can be achieved from sustainability to a tangible commitment: to develop strategies which meet both the sustainability and the financial requirements of clients

In contrast to the somewhat outmoded perceptions of sustainable investing as a process which constrains investment performance, we regard the successful implementation of this dual-pronged strategy as one which is additive to the investment process, offering the client an additional source of alpha and a reduction of risks.
Integration of sustainability into financial analysis

By changing their approach, mainstream asset managers can move beyond the limitations of sustainability screening discussed above. Most significantly, larger asset managers can drive sustainability into mainstream investment strategies by incorporating sustainability considerations into financial analysis. While several larger financial institutions have developed frameworks for sustainability integration, most of this work has been within sell side investment research as opposed to the underlying buy side investment research that has a direct impact on investment decisions. Larger buy side asset managers have continued to rely upon external 'ESG Research' providers. Historically, such providers have generated data and scores for screening, but they have not fundamentally modified the approach to financial analysis by incorporating sustainability factors into investment models and recommendations. Integrating material sustainability factors into the financial research which underlies actively managed strategies offers a more holistic approach and one which is consistent with the expectations of larger asset owners who have made commitments to integrate sustainability into their investment strategies.

Let us look more closely at a few examples of key sustainability considerations which analysts can assess as a means of building a more holistic view of a company's financial valuation.

One particularly relevant indicator for analysts is a company’s exposure to long-term sustainability trends, e.g., the Paris climate summit’s 2 degree scenario and how it changes their assumptions in the financial model around the long-term growth rate of the company. Here the analysis which has been done around the energy companies and the hypothesis of stranded assets offers an informative example5. Other considerations might be a company’s approach to the management of human capital and environmental factors and what insight that gives to the company’s overall cost management approach. Similarly, a company’s risk management and corporate governance policies can have a material influence on the discount rate used for future cash flows.

We can soon see that sustainability information provides key insights, both into the long-term trends and long-term management quality of companies. As such, it also provides a very useful way of integrating long-term information into financial modelling for the first time. Consequently, we believe that by explicitly integrating sustainability analysis into buy-side recommendations, mainstream asset managers can ensure client strategies take better account of the long-term risks, opportunities and competitive advantages of companies. This in turn allows asset owners to be assured that their asset manager is taking a long-term approach to their investment strategies, thereby aligning with their long-term fiduciary duties to which we alluded earlier. It also enables clients to benefit from an investment approach that is differentiated from the market’s short-term focus.

Establishing trust through collaborative innovation
Sustainability can offer a clear opportunity for collaborative innovation between asset managers and larger clients in particular. This in turn can foster a strong basis of trust – something which has been significantly challenged in the wake of the credit crisis.

Over the past decade, the asset management industry has been under increasing pressure as a result of the transition from active to passive strategies. This in turn has put intense pressure on fees, and consequently costs, throughout the asset management industry. Rather than viewing this trend as a threat, we believe asset managers should recognize the unique opportunity it gives them to adapt their approach towards clients and develop a clear understanding of their objectives and goals which, increasingly, include sustainability requirements. Sustainability issues can provide a unique means for clients and their asset managers to establish a dialogue around the clients’ specific needs and thereby work to develop solutions which meet those clients’ financial and sustainability objectives.

Importantly, such collaborations with institutional clients also often leads to innovations. Larger institutions tend to have the most demanding requirements in terms of sustainable investment. Working together with such clients can lead to new sustainable research frameworks and the development of new investment solutions. Collaborating to meet institutional client needs thus represents one of the most important drivers for moving sustainable investment forward, as it allows for the development of new strategies which fill existing gaps in the sustainable investment market.

Pursuing strategic engagements with companies focused on material improvements
An essential means whereby asset managers can provide tangible benefits to institutional clients is through effective engagement and stewardship that is aligned with the investment process. Engagement and stewardship which combine long-term fiduciary and sustainability goals can offer a compelling proposition for clients given the ever-growing degree of public scrutiny which asset owners now face concerning the social and environmental impacts of their investments. Asset managers can play a significant role in mainstreaming sustainability by engaging with those companies in which they are invested to make material improvements over time. While engagement within the remit of sustainable investing has often been pursued from an ethical perspective that is merely reactive to problems when they occur, mainstream asset managers actually have an opportunity to ensure that a) engagement is aligned with clients’ investment objectives and b) it is strategically organized around sustainability issues that have a material impact on long-term business performance. This allows asset managers to enhance their investment strategies by generating improvements in their core active holdings, offering long-term benefits for both shareholders and society as a whole.

Asset managers can support their engagement efforts through leading stewardship activities and exercising voting rights at general meetings of shareholders. Stewardship campaigns that improve transparency and management commitment to material sustainability issues can enhance shareholder value and lead to benefits for all market participants.
Changing the question of financial performance and sustainability to a commitment
Most significantly, mainstream asset managers have an historic opportunity to capitalize on the growing academic evidence that sustainability adds value to the investment process. In their 2014 paper, Cai and He observed a positive correlation between corporate environmental responsibility and long-term stock performance. Several recent studies have also demonstrated that a focus on the most material sustainability factors leads to better financial performance of companies and consequently more successful investment strategies. A wider adoption of sustainable investment strategies has not been held back by an absence of academic evidence. Rather, there has been a relative lack of institutional-level quality investment offerings building on this evidence that provide concrete opportunities for asset owners to commit larger sums of capital to sustainable investment strategies.

Ultimately, out-performance is not derived from any single set of data – be it sustainability or financial. Financial performance results from applying that data in a clear and consistent investment process by skilled analysts and portfolio managers with a proven track record, and from global insights into macro-economic trends and the developments at companies. Large, global asset managers are uniquely positioned to utilize their extensive financial resources and combine them with sustainability expertise in order to develop sustainable investment strategies with the scale and quality that institutional investors require. This combination represents the basis for establishing confidence among institutional investors that they can meet both their sustainability and their financial objectives in a manner consistent with their fiduciary obligations.

Conclusion: integration and innovation – a powerful combination
Mainstream asset managers are possessed of two important tools – a breadth and depth of financial resources which allows them to integrate sustainability into their financial analysis, together with the means by which they can collaborate and innovate with their clients to create solutions and strategies that meet the specific fiduciary and sustainable objectives of those clients. Combining these two factors, can, we believe, offer clients the opportunity for performance plus - the performance they have targeted, with the addition of robust, mainstreamed sustainability within their portfolio. This, we would argue, presents a compelling opportunity to transform sustainable investment from a form of normative investing driven by screening to a much more fundamental means of driving long-term value creation for larger-scale clients.

UBS AM Sustainable and Impact Investment Strategy
The Climate Aware Strategy

A UK pension fund faced the challenge of managing climate change risks in the passive portion of its equity portfolios. The fund needed to account for climate risks in its passive strategies while maintaining relatively strict limits on tracking error to the FTSE Developed World Index benchmark. An important factor was not only to limit exposure to current CO$_2$ emissions but also to manage future risks in order to ensure that the portfolio was aligned with the Paris climate summit’s 2 degree scenario and carbon reduction targets.

By combining environmental data from several sources, UBS Asset Management developed a portfolio optimization model which reduces exposure to climate risk while simultaneously maintaining the client’s restrictions on tracking error. Rather than simply reducing exposure to companies with higher CO$_2$ emissions, UBS AM’s team examined the trajectory of emissions reduction over time, as well as company management commitment to emissions reduction, to orient the portfolio toward companies that are better prepared for a low carbon future and the 2 degree reduction scenario. Moreover, the strategy reduces the exposure to, rather than excluding, companies with higher carbon risk in order to pursue strategic engagement with these companies. UBS AM’s engagement team explains the climate risks that have been identified from the research and provides concrete suggestions to these higher risk companies in order that they can learn and make improvements in their performance over time.

Impact measurement for public equities

A large Dutch pension fund needed to develop better disclosure to its beneficiaries on the social and environmental impacts of a portion of its global equity portfolio. Recognizing that such metrics go beyond ESG data provided by traditional sustainability research providers, the client needed an asset manager capable of measuring the external environmental and social impact of companies’ products and services. At the same time, they required an asset manager with global research and portfolio management capabilities that could deliver competitive active returns on its diverse portfolio of companies.

UBS Asset Management was able to meet the client’s objectives by establishing a research partnership with Harvard University’s School of Public Health and the City University in New York to develop a proprietary set of impact measurement metrics. UBS AM is leveraging the research of its global network of financial analysts to deliver strong financial performance while engaging with the companies directly to obtain greater insight into impact measurement. The metrics developed as part of the mandate are the first of their kind and can help provide a basis for other institutional investors to apply impact investment principles to various areas of their actively managed portfolios.
Both of these recent collaborations point to the importance of working directly with larger institutional investors to meet their combined financial and sustainability objectives. They also demonstrate how such collaborations can serve as an important basis for innovation. Innovative partnerships such as these will be essential in driving the assets of larger institutional investors into sustainable investment strategies over the next few years.

To learn more about Sustainable investing at UBS Asset Management please contact:

Michael Baldinger  
Global Head of Sustainable and Impact Investing  
Tel. +1 212 713 2000  
michael.baldinger@ubs.com

Christopher Greenwald  
Head of Sustainable Investment Research  
Tel. +41 44 235 1219  
christopher.greenwald@ubs.com
Whatever your investment profile or time horizon, we work with you to design a tailored sustainable solution to meet your objectives

Sustainable and impact investing approach

**Exclusion**
Screen and exclude companies or sectors that do not meet certain social, environmental or ethical criteria

**Integration**
Combine ESG factors with traditional finance considerations to make investment decisions

*Positive screening based on ESG ratings*: Focus on securities with strong ESG characteristics in combination with attractive financial fundamentals

*ESG integration*: incorporates ESG risks and growth opportunities into traditional security valuation and research process

**Impact investing**
Explicit intention to generate a measurable social and environmental impact alongside a financial return

Additional dimensions

**ESG research integration**
Sustainability considerations are integrated in UBS AM research process across asset classes

**Proxy voting and active engagement**

**ESG measurement and reporting**

Traditional UBS offering

Sustainable and impact investing offering
Your global investment challenges answered

Drawing on the breadth and depth of our capabilities and our global reach, we turn challenges into opportunities. Together with you, we find the solution that you need.

At UBS Asset Management we take a connected approach.

Idea and investment excellence
Our teams have distinct viewpoints and philosophies but they all share one goal: to provide you with access to the best ideas and superior investment performance.

Across markets
Our geographic reach means we can connect the parts of the investment world most relevant for you. That’s what makes us different – we’re on the ground locally with you and truly global.

A holistic perspective
The depth of our expertise and breadth of our capabilities allow us to have more insightful conversations and an active debate, all to help you make informed decisions.

Solutions-based thinking
We focus on finding the answers you need – and this defines the way we think. We draw on the best of our capabilities and insights to deliver a solution that’s right for you.

What we offer
We offer a comprehensive range of active and passive investment styles and capabilities, across both traditional and alternative asset classes. Our invested assets total CHF 703 billion\(^1\) and we have over 3,600\(^2\) employees in 22 countries.

Who we are
Backed by the strength of UBS, we are a leading fund house in Europe, the largest mutual fund manager in Switzerland and one of the largest fund of hedge funds and real estate managers in the world.

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\(^1\) Data as of 30 June 2017
\(^2\) Thereof around 1,200 from Corporate Center. Data as of 31 December 2016
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