Sustainable investing

Education primer: ESG thematic equities

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Rachel Whittaker, CFA, Analyst; Melissa Spinoso, Andrew Lee, Head of Sustainable and Impact Investing, andrew.lee@ubs.com; Alexander Stiehler, CFA, Analyst; Philippe G. Müller, CIIA, Head Global Investment Themes

- An ESG thematic approach invests in the equities of companies that stand to benefit from specific themes related to environmental, social or governance (ESG) factors.
- ESG thematic equities offer opportunities beyond a traditional index orientation and are well suited to satellite portfolios. They require a long-term investment horizon.
- ESG thematic strategies can be implemented via active or passive strategies, and diversifying across multiple themes can significantly reduce volatility relative to a conventional benchmark.

Our view

Sustainable investing (SI) is an investment philosophy that can be applied to a wide range of asset classes. It seeks to achieve competitive portfolio risk/return characteristics comparable with a traditional approach while also having a positive effect on the environment and society and/or aligning investors’ portfolios with their goals and values.

The ESG thematic equities approach identifies investment strategies that target specific environmental, social or governance (ESG) factors evident in growing global trends. It determines which industries and companies are best positioned to benefit from them, and constructs portfolios that take into account such insights. Examples include water management, climate change, access to education and healthcare, and gender diversity.

Investors can use investments in ESG thematic equities to direct capital toward issues they prioritize personally, while addressing the social and environmental challenges outlined by the UN Sustainable Development Goals (SDGs). In our view, equity thematic investments do not qualify as impact investing.

Due to their focus on structural trends, thematic strategies are expected to outperform over the long term. Multi-themed approaches can represent attractive core global equity exposure while single-themed strategies can be used as satellite investments to complement a more diversified core exposure.

This report is part of a series of short primers on key sustainable investing (SI) strategies. You will find more information on the client portal. You can also contact your advisor for assistance.

SI strategies are investment approaches defined by UBS that target market rate returns as well as social and environmental objectives. Each strategy is distinct in how it incorporates sustainability into the investment process, in its investment characteristics, and in how it seeks to address one or more of the primary objectives of sustainable investing:

- aligning investments with long-term sustainability goals, or personal values
- potentially improving portfolio risk/return characteristics by incorporating environmental, social, and corporate governance (ESG) criteria into investment decisions
- achieving a positive environmental or social impact alongside financial returns.

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What are ESG thematic equities?

ESG thematic investing strategies identify specific themes related to ESG factors, determine which industries and companies are best positioned to benefit from these trends, and construct portfolios based on this thematic framework. It differs from an ESG leaders approach in that it focuses on specific issues, not the companies’ overall average sustainability profile. Hence some companies could have weak performance on some ESG criteria, but be playing a role in providing products and services that address critical sustainability challenges.

Our approach to investing in ESG themes starts with the three key long-term global trends of population growth, aging and urbanization. It identifies the environmental and social challenges that arise as a consequence of these ongoing trends. These challenges pose risks but also represent opportunities for products and services that can address pressing needs such as affordable access to quality healthcare, clean water, and reducing or mitigating rising pollution.

The scale of these opportunities implies the potential for attractive commercial returns alongside the positive social and environment effects these investments can produce. As a result, we expect companies active in these areas to increase their earnings at an above-average rate over a full economic cycle.

Examples of relevant environmental themes include water and waste management, ways of improving energy efficiency and climate change mitigation and adaptation solutions. Social themes include supply chain management, access to personal financing, and methods of ensuring better housing, education and healthcare, while governance themes address issues of board diversity and corporate transparency (see Fig. 1 for the CIO framework for identifying long-term themes and companies associated with them).

Table 1 displays a number of themes within our long-term investment (LTI) framework that offer exposure to companies with solutions to pressing sustainability challenges. All of them relate closely to one or more of the challenges addressed in the SDGs listed in Fig. 2. The LTI list is not exhaustive and is continually being expanded with new themes. We publish research on each theme, with detailed descriptions of the thematic drivers and the industries or technologies that profit from them.

Investors can employ ESG thematic approaches as both core and satellite investments, and can direct capital toward issues they prioritize personally while addressing the social and environmental challenges outlined by the SDGs. ESG thematic investing is an important way for investors to signal support for, and contribute to, specific social and environmental themes and outcomes.
Table 1: Investment opportunities that help address the UN Sustainable Development Goals
CIO long-term themes with sustainability angle

<table>
<thead>
<tr>
<th>Theme</th>
<th>Associated UN SDGs</th>
<th>Investment Opportunity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Water scarcity</td>
<td>2, 8, 15</td>
<td>Water infrastructure, treatment and management, agricultural technology (e.g. enhanced irrigation)</td>
</tr>
<tr>
<td>Waste management and recycling</td>
<td>6, 11, 15</td>
<td>Waste management, with particular focus on emerging markets</td>
</tr>
<tr>
<td>Agricultural yield</td>
<td>2, 6</td>
<td>Agricultural equipment, biotech, irrigation technology, fertilizer producers</td>
</tr>
<tr>
<td>Clean air and carbon reduction</td>
<td>3, 11</td>
<td>Renewable energy, energy efficiency &amp; storage, clean fuels, emission control technology, carbon capture/storage</td>
</tr>
<tr>
<td>Emerging market infrastructure</td>
<td></td>
<td>Transportation infrastructure, water supplies, sanitation services, affordable housing, utilities</td>
</tr>
<tr>
<td>Energy efficiency</td>
<td>7, 11, 13</td>
<td>Building systems, industrial processes, transportation infrastructure, technology/software</td>
</tr>
<tr>
<td>Renewable energy</td>
<td>7, 11</td>
<td>Renewable energy project developers, wind turbine and solar PV manufacturers, utilities</td>
</tr>
<tr>
<td>Mass transit rail</td>
<td></td>
<td>Companies with high exposure to mass transit rail (incl. contractors, capital equipment suppliers, operators, and property developers)</td>
</tr>
<tr>
<td>Automation and robotics</td>
<td>12, 13</td>
<td>Industrial automation/robotics technology/industrial software</td>
</tr>
<tr>
<td>Educational services</td>
<td>5, 10</td>
<td>Education service companies</td>
</tr>
<tr>
<td>Emerging market healthcare</td>
<td>3, 10</td>
<td>Healthcare equipment &amp; supplies, healthcare providers &amp; services, pharmaceuticals and biotechnology companies</td>
</tr>
<tr>
<td>Generics</td>
<td>3, 10</td>
<td>Generics manufacturers</td>
</tr>
<tr>
<td>Medical devices</td>
<td>3, 10</td>
<td>Manufacturers of medical devices such as orthopedic implants, cardiovascular devices, dental implants, corrective lenses, or hearing aids.</td>
</tr>
<tr>
<td>Obesity</td>
<td>3, 10</td>
<td>Consumer (healthy food, fitness &amp; sportswear), healthcare (treatment of obesity &amp; related diseases)</td>
</tr>
<tr>
<td>Oncology</td>
<td>3, 10</td>
<td>Biopharmaceutical companies with strong exposure to oncology</td>
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<tr>
<td>Retirement homes</td>
<td>10, 12</td>
<td>Real estate companies with high exposure to senior housing, companies specialised on nursing homes, outpatient care</td>
</tr>
<tr>
<td>Retirement planning</td>
<td>10, 12</td>
<td>Companies with meaningful revenue exposure to wealth management services, asset management and life insurance.</td>
</tr>
<tr>
<td>Safety and security</td>
<td>10, 12</td>
<td>Products and services that focus on cyber-security, testing, inspection &amp; certification, life science tools, and commercial and residential construction security</td>
</tr>
</tbody>
</table>

Please contact your contact advisor to be subscribed to these themes and receive and/or receive detailed publications on the above-mentioned investment themes. *Exposure to certain long term investment themes can also be achieved through impact investments, which generally involve illiquid private markets vehicles and necessitate tolerance for significant illiquidity.

Source: UBS Chief Investment Office
Performance considerations

Generalized statements about the performance of ESG thematic equities are difficult to make, given the variety of themes and approaches. Typically, thematic strategies are not managed explicitly against a benchmark, though their performance is often measured against that of a global benchmark such as MSCI ACWI, which represents the universe of potential investments. Based on themes and trends that generally feature above-average growth prospects relative to world markets, ESG thematic strategies are expected to outperform over the long term. While thematic concentration may imply certain sector overweights, industry and political dynamics can vary considerably across themes and sectors.

Also, some themes are cyclical, while others are defensive or counter-cyclical. Investors taking a thematic approach must have a sufficiently long-term investment horizon, and not fixate on tracking a standard benchmark on a short-term basis. Thematic investment approaches may contain small and midcap companies not represented in well-known benchmarks, thereby offering investment and diversification opportunities beyond a traditional index orientations (UBS, 2018).

Even when themes are combined to take advantage of different industry dynamics, having an overarching macroeconomic or top-down view on the relative attractiveness of specific themes is advisable. Potential outperformance can be generated by picking and combining the right themes, as well as by picking the right stocks to express these themes. In practice, many thematic funds apply a bottom-up approach; that is, they start the process by identifying the stocks with the most attractive properties across themes, and only later reconcile the selection with theme diversification targets. However this does not mean that an ESG thematic strategy will necessarily stray significantly from its benchmark, as it depends on the specific approach and benchmark adopted (see next section, ‘how to invest in ESG thematic equities’).

Figs. 3 and 4 depict how a selection of water and clean energy funds has performed, illustrating two dynamics: first, fund returns can differ considerably even within a single theme. This is particularly the case for clean energy, where fund performance is highly linked not only to the performance of renewables but also to the performance of specific types of renewables, highlighting the importance of sub-theme and stock selection. Second, different themes can have very different performance trajectories due to distinct return drivers, which underlines the importance of ensuring diversification across themes.

According to the Global Sustainable Investment Alliance (2016), the fastest-growing sustainable investment strategies between 2014 and 2016 were impact/community investment (146%) and sustainability themed investment (140%), both of which are also the smallest in absolute dollar terms.
How to invest in ESG thematic equities
Approaches to ESG thematic investing in listed equities can vary by such factors as the instrument chosen, the level of diversification and whether the strategy is active or passive.

Funds or single stocks
Investors can select individual equities for a stock portfolio to gain exposure to specific themes. Doing so provides greater control and targeted exposure, but introduces potential concentration risk. Investing in funds enables greater diversification and active management, but the investor has less control over which themes are addressed.

Multi-theme or single-theme
Investors and fund managers can pursue multiple themes or a single theme depending on interest. Short and long-term performance of individual themes will be driver-specific and can deviate considerably from standard benchmark performance. Single-theme funds or portfolios represent attractive choices for satellite investments. For core exposure, we generally recommend diversifying with a multiple-theme approach. Analysis of historical performance suggests that approaches focused on a single theme are likely to experience greater volatility relative to conventional benchmarks such as MSCI World than approaches selecting multiple themes.

Active or passive
ESG thematic investing lends itself well to active management. Financial and ESG data is not always as available or of high quality, especially for small and medium-sized companies, where pure-play exposure to certain themes is greatest and necessitates thorough diligence. For multi-theme funds, the relative weighting of different themes over time can significantly affect performance, which speaks for a more active approach. However, passive ETF exposure is increasingly available for certain thematic indices, such as the S&P Water Index and the Solactive Equileap Global Gender Equality Index.

Pure plays or large caps
Explicit thematic exposure can lead to a bias toward pure-play companies, which can be small or medium sized and not represented in well-known benchmarks. This offers opportunities beyond a traditional index orientation, and is well suited to satellite portfolios. ESG themes can also target large-cap companies that provide meaningful but not pure-play exposure. While this approach may produce a less-targeted portfolio, it can provide exposure that is closer to benchmark and offer an interesting alternative to a “conventional” large-cap portfolio.

Fig. 5 contains a short list of questions that can assist investors selecting thematic ESG equity funds.

Key risks
Thematic investing is a well-established equity investment approach, encompassing broad-based trends and sector themes other than ESG themes. As such, the usual risks of investing in an
equity portfolio apply to an ESG leaders approach, but there are also a number of thematic and ESG specific risks:

- **Potential for higher volatility**: Focusing on single themes, individual equities and/or smaller companies may result in higher volatility and lower correlation to standard benchmarks. This offers the potential for outperformance, but such portfolios may also underperform over certain time periods given their concentrated exposure to highly theme-specific dynamics. The long-term nature of these themes means that they are well suited for investors with a long-term investment horizon.

- **Unintended SI exposure**: Thematic ESG investing should focus on companies with sustainable business practices whose products and services address key sustainability challenges. There is always a risk that companies will not apply minimum standards with respect to ESG factors and, perhaps more critically, may not consider or address the unintended consequences of their activities and negate the other positive effects they are achieving.

### Social and environmental contribution

ESG thematic strategies enable investors to invest a portion of the equity allocation in their liquid portfolio in companies whose products, services and approaches target specific themes that address the social and environmental challenges important to them.

Due to the clear connection between thematic investments and the SDGs, investing in ESG themes via listed equities is being increasingly marketed as impact investing. We do not consider it such, however.

UBS defines impact investments as those that finance companies, organizations, and funds with the intention of generating social or environmental impact alongside a financial return. In practice, we consider three criteria alongside the generation of desirable financial returns to delineate what qualifies as impact investing: a stated and explicit intention to generate positive social and/or environmental impact in addition to sustainable financial performance; that the outcomes of the investment be tied to specific metrics, and measured against a base case or benchmark; and verification that the invested capital itself is positively correlated with the intended outcome. We also look for additionality - measured against a business-as-usual or base case scenario, would the capital have been allocated, or the social/environmental impact created regardless of the investment (UBS, 2016). This definition aligns with that of the Global Impact Investing Network (GIIN).

Since investments in listed companies simply transfer ownership of them in a secondary market from one shareholder to another, this aspect is not fulfilled, in our view. Nevertheless, ESG thematic equities enable investors to contribute to broader social and environmental objectives aligned with their personal values through their portfolios.

Although thematic approaches fall short of meeting the criteria required for impact investing, they enable investors to signal to companies the importance of aligning their products, services and
approach in ways that contribute to specific social and environmental themes and outcomes.

References

UBS CIO Wealth Management (2016). Doing well by doing good.

UBS CIO Wealth Management (2018). Longer Term Investments.

### Terms and Abbreviations

<table>
<thead>
<tr>
<th>Term / Abbreviation</th>
<th>Description / Definition</th>
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<th>Description / Definition</th>
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</thead>
<tbody>
<tr>
<td>A</td>
<td>actual i.e. 2010A</td>
<td>COM</td>
<td>Common shares</td>
</tr>
<tr>
<td>E</td>
<td>expected i.e. 2011E</td>
<td>Shares o/s</td>
<td>Shares outstanding</td>
</tr>
<tr>
<td>UP</td>
<td>Underperform: The stock is expected to underperform the sector benchmark</td>
<td>CIO</td>
<td>UBS WM Chief Investment Office</td>
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