Adding value(s) to investing

Sustainable investing

March 2015
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Don’t judge each day by the harvest you reap, but by the seeds you plant.

*Robert Louis Stevenson* (1850–1894), writer
Dear readers,

Sustainable investing is a force to be reckoned with. UBS’s stakeholders – clients, employees, investors, government agencies, and civil society – are concerned about the broader impact of business activity and the investment community’s response. These changing expectations are affecting how companies operate. Many are already managing relevant risks and seizing related opportunities. Investors are also increasingly incorporating environmental, social, and governance factors into their decisions.

This report covers the why, what, and how of this field. First, it highlights reasons and motivations to get involved. It then presents three building blocks for a sustainable investing strategy. Finally, it considers how to implement them in portfolios.

UBS is committed to running businesses, supporting employees, and helping clients operate according to sustainable and responsible principles. We have accomplished a great deal in this area with respect to our practices, risk policies, and corporate social responsibility programs. However, we are now taking
steps to embed this approach more broadly within our DNA. Our global goal is to develop a comprehensive, industry-leading platform of research, advice, and products that is dedicated to sustainable investing and philanthropy.

UBS believes sustainable investing is here to stay, and we will continue to work to fulfill clients’ needs in this area, now and in the years to come.

Sincerely,

Jürg Zeltner
CEO, UBS Wealth Management

Bob McCann
CEO, UBS Group Americas

Mark Haefele
Global CIO, UBS Wealth Management

Caroline Anstey
Global Head UBS and Society
**Introduction**

**Adding value(s) to investing**

In recent years, growing portions of society have raised concerns about the prevailing economic growth model. The visible impact of human activities on the natural environment, resource scarcity in an expanding global economy, greater awareness of the waste inherent in many traditional business models and of the limitation of various corporate governance practices have driven a broad change in mindset. At the same time, we are seeing a growing realization that companies can be at the heart of solutions to many of the world’s social problems.

Recently, The Millennium Project – a global research think tank – identified 15 global challenges, a clear majority of which are directly related to sustainability concerns (see Fig. 1).

The investment community has also recognized these issues, and a sustainable investing (SI) industry has emerged, which is now shifting from the fringes to the mainstream of the financial landscape.

This introduction to SI is targeted at investors new to the field as well as those with some familiarity who wish to learn more.

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**Fig. 1: The 15 global challenges facing humanity according to The Millennium Project**

| Sustainable development and climate change | Education |
| Clean water | Peace and conflict |
| Population and resources | Status of women |
| Democratization | Transnational organized crime |
| Global foresight and decision making | Energy |
| Global convergence of IT | Science and technology |
| Rich–poor gap | Global ethics |
| Health issues |

Note: The Millennium Project was initiated by the Smithsonian Institution, the Futures Group International and the United Nations University in 1996.
Introduction

Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

The United Nations’ Brundtland Commission provided the landmark definition almost 30 years ago that still best captures the essence of sustainability.
Chapter 1

Sustainability: Why now?

Changing attitudes in society underpin sustainable investing

The human race is challenged more than ever before to demonstrate our mastery, not over nature but of ourselves.

Rachel Carson (1907–1964), conservationist
Sustainable investing (SI) is growing faster than the financial industry at large. The key driver is society’s changing attitudes regarding sustainability questions. In particular, various stakeholder circles within society have evolved in their expectations regarding the appropriate role and behavior of corporations in recent years. The attitudes of consumers, employees, investors and civil society at large are changing perceptibly. These stakeholders are placing more stringent demands on companies (see Fig. 2).

In a 2014 survey of 30,000 respondents across 60 countries, Nielsen, a consumer research firm, found that:

- 55% of respondents are willing to pay extra for products and services from companies that are committed to positive social and environmental impact, up from 45% in 2011 (see Fig. 3 on pg. 15).
- 52% of respondents reported having purchased at least one product or service from a socially responsible company during the last six months.
- 67% would prefer to work for a socially responsible company.

The rising influence of the Millennial generation – those born between the early 1980s and early 2000s – and their idealism is an important driver behind this shift in societal expectations. Even though Millennials still do not control a significant share of investable assets, their impact is being felt through how they are shaping demands on companies from different stakeholder groups.

In many countries, the result of these shifting expectations is or is likely to be government involvement either through lawmaking or regulation. At that point, societal demands become binding on companies. The key is that whether through stakeholder demands or government rules, these trends are affecting the operating environment for companies, who now ignore such considerations at their own risk.

Evidence gathered in listed markets over the last few decades shows no significant performance difference between sustainable investing and conventional approaches.

Investors catching on
The SI movement has gathered steam as a result of evolving investor demand. Growth in the number of financial firms that have signed on to the UN Principles for Responsible Investment (PRI), as shown in Fig. 4, offers evidence of the adoption rate. The Principles are a set of six voluntary, aspirational commitments to incorporate environmental, social, and governance (ESG) factors into an institution’s investment decision making and ownership practices. Members report publicly on their own progress, thereby promoting more widespread adoption and implementation of the Principles. The PRI stands at the focal point of an international network of investors established to help members put the Principles into practice through shared resources.

**UBS CIO definition of sustainable investing (SI)**

We define SI as a set of investment strategies (exclusion; integration; impact investing) that incorporate material environmental, social and governance (ESG) considerations into investment decisions. SI strategies usually seek to reach one or several of the following objectives: 1) achieve a positive environmental or social impact alongside financial returns; 2) align investments with personal values; and 3) improve portfolio risk/return characteristics.

<table>
<thead>
<tr>
<th>Investment community</th>
<th>Corporations</th>
<th>Society</th>
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<tbody>
<tr>
<td>• Investors</td>
<td>• Borrowers &amp; issuers</td>
<td>• Consumers</td>
</tr>
<tr>
<td>• Intermediaries</td>
<td>• Employers</td>
<td>• Government</td>
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<tr>
<td>• ESG research providers</td>
<td>• Consumers of resources</td>
<td>• Civil society</td>
</tr>
<tr>
<td>• Trade associations</td>
<td>• Sellers of goods &amp; services</td>
<td></td>
</tr>
<tr>
<td>• Standard setters</td>
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Source: UBS
**Corporations rising to the challenge**

Corporate leaders also recognize the challenges that lie ahead. To satisfy growing investor demands, corporations are engaging with the investment community on related issues. In particular, transparency and corporate responsibility (CR) reporting are on the rise. The audit firm KPMG found in a 2013 survey that CR reporting is undertaken by almost three-quarters (71%) of the 4,100 companies surveyed worldwide, an increase of seven percentage points since 2011.

In addition, a 2013 UN Global Compact–Accenture survey of 1,000 CEOs across 103 countries found that 93% believe that sustainability will be important to the future success of their business. This highlights the growing recognition that it is not only a risk consideration for companies but also a competitive differentiator. At the same time, only 32% of the respondents believe that the global economy is on track to meet the demands of a growing population within environmental and resource constraints.

**SI around the globe**

In the US, interest in SI has traditionally been driven by institutional investors such as pension funds. More recently, the trend has started to catch on with university endowments. Harvard University’s endowment signed the UN PRI initiative last year and is now one of 1,353 signatories worldwide (see Fig. 5 on pg. 15). Stanford University announced in May 2014 that its endowment was divesting from coal companies. The trend is gradually spreading to individual investors as well. In particular, younger individuals from the Millennial generation, who are beginning to enter the investment community, have consistently placed a greater emphasis on SI than their parents and grandparents did, thereby catalyzing the change in attitudes.

In Europe, institutional investors have played a key role in the spread of SI as well. In addition, governments are facilitating adoption through regulation. At least eight countries have related national regulations that directly impact their pension systems: United Kingdom, France, Germany, Sweden, Belgium, Norway, Austria, and Italy.

In Asia, the approach has gained traction in recent years. According to the Asia Sustainable Investment Review, SI assets in Asia ex-Japan stood at USD 45bn, growing at a 22% annualized rate (2011–2013). A further strong government policy impetus can be expected on the back of the March 2015 Chinese anti-pollution documentary *Under the Dome* which has graphically highlighted China’s environmental plight. Several Asian governments including China and Indonesia have recently introduced significant green financing initiatives.

The result of these parallel trends: SI has come a long way and can now be considered an established subsector of the investment industry. It has evolved from modest origins anchored in a faith-based perspective with an emphasis on avoiding undesirable investments in the first half of the last century, to a more disciplined approach that has now reached a level of maturity, organization and broad acceptance (see timeline on pg. 14).

**What drives investors to SI?**

Investors are usually drawn to sustainable investing by one, and often a combination of, these three motivations:

1. A belief that portfolio risk/return characteristics can be improved by factoring sustainability into investment decisions
2. A willingness to exert a positive impact on society and the environment through their investments
3. A desire to align their financial portfolio with their personal values

1) **Improved expected portfolio risk and/or return:** The rationale behind this motivation is that the wealth of sustainability-related information available is not fully considered by the mainstream investment community when selecting investments, due either to a lack of familiarity or a tendency to focus on short-term value drivers. Integrating such factors into security selection along with traditional financial factors can be considered a means to better identify growth opportunities or business and reputational risks relevant for companies.

2) **Positive impact:** Exerting a positive social and/or environmental impact through investments is gaining popularity. One focus can be on actively directing capital to the best companies according to environmental, social and governance criteria. A second focus can be on shareholder engagement to influence corporate decisions, which is sometimes a desired feature of professionally managed funds. The most progressive version of this motivation is achieved through impact investing (see Chapter 2), investments made with the explicit intention to generate a measurable social and environmental impact alongside a financial return.

3) **Values alignment:** This is probably the most traditional motivation for SI. Originating among faith-based investors, its resonance has broadened over time. This motivation is often associated with exclusionary approaches that eliminate companies or industries active in areas deemed incompatible...
with the investor’s value system. The main benefit here is the peace of mind the investor enjoys in knowing that he or she is not financing such activities. The performance motive is not a key driver, though there is usually an expectation that performance will not be negatively affected by the approach.

**Unjustified performance concerns**

When considering SI, investors often ask whether such strategies hinder financial performance. Interestingly, evidence gathered in listed markets over the last few decades shows no significant performance difference with conventional approaches. This can be illustrated by comparing the performance of the stock indexes that incorporate SI principles with that of regular stock indexes (see Fig. 8).

Performance differences can occur in specific markets and time periods, but on balance across markets and through full market cycles, evidence suggests that SI performs no better and no worse than traditional approaches. A UBS CIO survey of academic studies analyzing performance relative to conventional approaches (see Fig. 7) confirms this. Performance should therefore not be expected to differ meaningfully from that of conventional investments.
Ask the investor

Investors engage in sustainable investing for different reasons. Alexander Stiehler discussed motivation and perspective with Philipp Cottier.

Philipp Cottier: Individual Investor, Zürich, Switzerland

Alex Stiehler: How did you become involved in sustainable investing? Was there a specific cause?

Philipp Cottier: I used to run a fund of hedge funds company in Zurich. It was institutionally focused, and in 2007 we launched globally the first SRI²-compliant hedge fund portfolio in cooperation with Scandinavian institutional investors. We were also the first fund of hedge funds to sign the United Nations Principles for Responsible Investment in 2008. A few years earlier in 2005, my wife and I had started a foundation which supports “girl empowerment” projects in Nepal and East Africa. The foundation’s assets are 100% invested in sustainable and impact investment strategies. Roughly 50% are invested in liquid stocks and bonds mandates, while the rest is invested in less liquid social impact investments including microfinance, small and medium-sized enterprise financing, energy access, agriculture, social housing, education and healthcare.

What motivated you to engage in sustainable investing?

I originally started investing part of my private assets according to sustainability criteria based on personal convictions. Microfinance, for instance, tends to provide stable, uncorrelated returns and has a long track record. Within the foundation I was motivated to align investments with the foundation’s mission. However, since it’s not possible to align every investment thematically with the institution’s mission, a broader SRI and social impact strategy seemed to be the best approximation. Regarding the hedge fund company, we were in contact with institutional investors, in particular from Scandinavia, who were obliged to invest their assets sustainably.

When making investments, how do you weigh the importance of financial returns against achieving a positive social impact?

For liquid SRI investments, I expect a similar performance as for traditional non-SRI strategies, and this has proven to be the case so far. Early on, one could only invest sustainably in equities, more recently fixed income solutions have also emerged. The universe is constantly growing.

As far as microfinance debt and equity are concerned, we have so far achieved returns in line with expectations for microfinance debt, i.e. Libor + 3% p.a., while equity investments will most likely result in net IRRs (internal rates of return) in the high single or low double digits. In social housing in Latin America, we have also achieved good returns. There are other areas, in which we’ve only started investing recently – such as energy access and micro grids – and where there is no track record to speak of. Education and healthcare are also at an early stage, and we’ve only started taking a deeper look at them. In sum, in well-established areas there are good possibilities to generate returns, while in others it’s still too early to tell.

Do you perceive a tradeoff in making sustainable investments?

As mentioned, with sustainable investing in liquid SRI assets, there should be no tradeoff. I expect the same return as from conventional strategies. After all, we’re talking about successful, best-in-class companies that emphasize environmental, social and governance (ESG) considerations as an additional dimension.
Sustainability: Why now?

With social impact investing, things are more complicated. I believe it is difficult to make money at the very base of the pyramid (BoP). Margins are razor thin and large sums must be invested to gain sufficient scale to achieve profitability. For example, in microfinance projects, large time and resource commitments must be made into financial literacy training, loan monitoring and loan collection. Another example is social housing in Latin America, where it is very difficult to earn a return for lowest income class projects. BoP projects are often done more successfully as a venture philanthropist or an NGO.

However, one layer above the BoP, i.e. the upper part of the lower income population, microfinance and social housing work well. With small and medium-sized enterprises there are also good opportunities to achieve a good financial return and a positive social impact at the same time. Now, if one is active in the upper half of the low income population, for instance in microfinance or in SMEs, this will also help the BoP because one is investing in the development of the financial and other sectors, which helps the entire economy and also pulls up people at the BoP.

For our foundation, it is important that our impact investments generate real financial returns similar to normal private debt and private equity returns, since the asset side of the foundation funds the grants on the liability side. So while the liability side of the foundation has a strict social objective, namely girl empowerment, and can only support girl empowerment projects with grants, the asset side of the foundation must invest to yield both a financial return comparable to market returns, as well as a social return. The social return or impact can however be achieved in many different ways and is not constrained to girl empowerment, as this would be too narrow.

How is sustainable investing accepted in your social and business environment?

In my private surroundings the level of acceptance and interest has been rising considerably. The same holds true for most family offices and foundations I meet. Still missing today is greater interest from institutional investors – such as pension funds and insurance companies – in continental Europe. Most banks haven’t yet shown great interest, either. I truly hope that social impact investments will establish themselves as their own asset class in the future, and that all investors will monitor and rebalance their portfolios according to sustainability criteria in order to achieve both financial and social returns.
## Evolution of sustainable investing (SI)

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<th>Events</th>
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<tr>
<td><strong>1920s</strong></td>
<td>1928: The Pioneer Fund established to enable investors to avoid companies involved in gambling, tobacco and alcohol.</td>
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<tr>
<td><strong>1950s</strong></td>
<td>1953: Howard Bowen coins the term corporate social responsibility (CSR) in his book <em>Social Responsibilities of the Businessman</em>.</td>
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1971: Pax World Funds founded as the first ethical mutual fund.  
1977: The Sullivan Principles developed, which encouraged divestment and ultimately forced businesses in South Africa to draft charter calling for end to apartheid. |
| **1980s** | 1985: The Social Investment Forum established to advance investment practices that factor in environmental, social and governance (ESG) considerations.  
1987: Brundtland Commission coins its sustainable development definition.  
| **1990s** | 1990: The Domini Social Index is created.  
1999: The Global Reporting Initiative (GRI) launched; over 11,000 companies now use the GRI framework. |
| **2000s** | 2006: The UN launches its Principles for Responsible Investment (PRI) with the goal of creating a sustainable financial system.  
| **2010s** | 2010: The International Integrated Reporting Council (IIRC) launched to promote corporate reporting of all aspects of value creation.  
2013: The Sustainability Accounting Standards Board (SASB) publishes its first industry-specific standard.  
2014: Interest in fossil fuel divestment and portfolio carbon footprint measurement picks up among institutional investors. |

Source: UBS
Chartbook

Fig. 3: Consumers increasingly willing to pay for positive impact
Percent willing to pay extra for products and services from companies committed to positive social and environmental impact

Fig. 4: UN Principles for Responsible Investment
1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles with the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

Source: UN PRI, UBS, as of 2 March 2015

Note: ESG = environmental, social and governance

Fig. 5: Growing number of investors committed to sustainability
UN Principles for Responsible Investment signatories and assets

Source: UN PRI, UBS, as of 2 March 2015

Fig. 6: SI assets in the US
USD billion

Source: US SIF, as of 2014

Fig. 7: Academic studies on relative performance of SI show inconclusive picture
Number of studies showing positive, neutral and negative performance of SI versus conventional investments

Source: UBS, 2014
Note: Only includes studies published 2000 or later

Fig. 8: SI and conventional investing perform similarly
April 1990 – February 2015, in %

Source: Bloomberg, as of February 2015
Chapter 2

Sustainable investing approaches

Building blocks of a sustainable investing (SI) framework

Not everything that can be counted, counts; and not everything that counts can be counted.
William Bruce Cameron, sociologist

Having discussed what drives investors to SI and what they seek to achieve through such a strategy, we now turn to available approaches. UBS CIO has developed a framework to guide investors on how it fits into the overall investment advice picture (see Fig. 9).

The CIO framework comprises three main approaches: Exclusion, Integration, and Impact Investing. These can be integrated into an asset allocation and portfolio construction process that is common to both conventional strategies and SI. The two additional features – sustainability-themed investing and shareholder engagement – can be incorporated across the three main approaches.

Delineation with related areas
While SI incorporates sustainability considerations into investment decisions, conventional approaches generally do not. In conventional portfolios, when such considerations do enter the equation, they are typically not explicitly acknowledged, or the affected assets represent a small fraction of the portfolio. Later, we discuss how it is possible to include sustainability-oriented investment themes as a small fraction of an otherwise non-SI portfolio.

SI and philanthropy differ in their profit motive. While some SI activities seek to achieve a positive social and/or environmental impact, the profit motive is nevertheless always present. Philanthropy does not include this motive.
Approaches to sustainable investing – three pillars

**Exclusion: Achieving peace of mind**
This traditional and probably still most common approach excludes individual companies or entire industries from portfolios if their areas of activity conflict with an investor’s values. This process, called exclusionary or negative screening, can be quite flexible. It can rely either on standard sets of exclusion criteria or be tailored to investor preferences. For instance, investors may wish to exclude companies with 5% of sales or more generated from alcohol, weapons, tobacco, adult entertainment or gambling — so-called “sin stocks.” Some faith-based investors also exclude companies involved in contraception and abortion-related activities.

In the case of government bonds, investors may seek to avoid an entire country based on the sovereign’s compliance with select international standards (e.g. human rights or labor standards). Note that there can be some regional variation about the desirability of excluding certain activities such as nuclear power or genetically modified organisms (GMOs). The exclusion approach can also be applied in combination with the integration approach, discussed below. In general, one of the major criticisms of this approach is that it reduces the investable universe.

**Integration: The combination of sustainability and financial analysis**
This approach encompasses techniques that combine environmental, social and governance (ESG) factors with traditional financial considerations to make investment decisions. This broad category includes two specific approaches that are often blended in practice. Compared to exclusion, both approaches generally lead to portfolios with a more balanced sector composition.
1. **Positive screening a.k.a. best-in-class screening** uses ESG performance criteria and financial characteristics to select the best companies within an industry or sector, usually relying on a sustainability rating framework. This is usually a more knowledge-intensive process than exclusionary screening because it requires understanding which factors are relevant for each industry and evaluating individual issuers on each of these factors.

2. **ESG integration**, unlike positive screening, seeks to incorporate material ESG risks and growth opportunities directly into traditional security valuation (e.g., through inputs such as earnings, growth or discount rates) and portfolio construction. This approach has gained traction in recent years and is based on the premise that additional ESG information not covered by traditional analysis could have an impact on the long-term financial performance of a company. ESG integration involves understanding how companies handle social, environmental and governance risks that could damage their reputations and whether they are positioned to capture ESG opportunities that could give them a competitive edge.

### Impact investing: Making a difference

Impact investing explicitly seeks to generate a positive social or environmental impact alongside a financial return, unlike other SI approaches, where progress on social and environmental issues may be a by-product of financial enterprise. The niche market of impact investing is growing fast. Examples include community investing, variants of microfinance, as well as private equity-like deals investing in such sectors as education, healthcare, basic infrastructure and clean energy.

In the ongoing debate about how strict the definition of impact investing should be, some practitioners are inclined to require financial returns to be contingent upon a measurable social or environmental outcome. We believe that a broader and more flexible approach will be needed to accommodate the growth of impact investing.

Our solution delineates “mainstream” and “catalytic” categories of impact investing, based on nine criteria (see box below). Mainstream impact investments must fulfill four
of the criteria, including that of explicit intention to generate a social and environmental impact alongside a financial return. Catalytic impact investments, in contrast, must meet all nine criteria and should achieve a transformational impact beyond their designated project. Illustrative transformations include altering the behavior of non-impact-motivated participants within the targeted sector, or broadening impact investing’s appeal through financial instrument innovation. This dual approach should widen the investable universe for impact investing, while maintaining its integrity and accountability.

**Additional dimensions of SI**

*Sustainability-themed investing* identifies themes related to environmental, social or governance factors, determines which industries and companies are positioned to benefit from these trends, and constructs portfolios that factor in such insights. Examples of such themes include water and waste management, food scarcity, energy efficiency or climate change on the environmental side; supply chain management or access to finance, housing, education and healthcare on the social front; and board diversity or corporate transparency as far as governance is concerned. By directing assets to these themes, investors can pursue return opportunities and express their interests with satellite investments. The thematic angle can also help populate core portfolio investments or inform the selection of impact investing vehicles. We therefore consider it integrated into the three approaches described above as a building block.

For example, within impact investing, a private equity fund may invest in educational ventures, a typical SI investment theme. Within an integration approach, an ESG fund manager may select companies based on their resource efficiency or board diversity. Finally, within an exclusion approach, an investor may decide to divest from coal companies based on views about the climate change theme. When structured as stand-alone investments, such themes can be included even in non-SI portfolios.

*Shareholder engagement* (also known as activism) is a common feature of professionally managed sustainable investing. It can be combined with the various approaches above to leverage shareholder influence and attempt to shift corporate behavior toward greater compliance with ESG principles. Influence can be exerted by investors through direct communication with corporate management or by filing shareholder proposals and proxy voting. Sustainability-focused fund managers are often active in this area. The influence of shareholder engagement on ESG issues has risen in recent years, the major categories of proposals being political activities of corporations, the environment, human rights/diversity, and governance.

Although positive impact is often viewed as a distinguishing feature of impact investing, *shareholder engagement can be an effective instrument to exert positive impact* through investments in listed securities through the induced change in behavior of the targeted corporations.

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**Fig. 10: Exclusionary screening and integration dominate**

<table>
<thead>
<tr>
<th>SI assets under management, in USD billion</th>
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<tr>
<td>Negative/exclusionary screening</td>
</tr>
<tr>
<td>Integration</td>
</tr>
<tr>
<td>Corp. engagement and shareholder action</td>
</tr>
<tr>
<td>Noms-based screening</td>
</tr>
<tr>
<td>Positive/best-in-class screening</td>
</tr>
<tr>
<td>Sustainability themed investing</td>
</tr>
<tr>
<td>Impact/community investing</td>
</tr>
</tbody>
</table>

Source: Global Sustainable Investment Alliance (GSIA), 2014

**Criteria for impact investments**

- Investment generates product or service with positive impact on society or environment.
- Value chain with no adverse impact on society and environment.
- Project team is credible.
- Project implementation plan is credible.
- ESG-audited
- Social impact measurement
- >75% of fund investment on impactful activities
- Global assets under management <USD 30bn
- Catalytic
Chapter 3

Executing your sustainable investing strategy

Questions to consider prior to implementing

Though no one can go back and make a brand new start, anyone can start from now and make a brand new ending.

Carl Bard (1907–1978), theologian

To build an SI portfolio, we first consider how different asset classes can be viewed from a sustainability perspective, in both public and private financial markets. Investors must make a few simple decisions before engaging in this area, and these choices affect the resulting asset allocation approach. We then touch on several critical implementation questions.

From sustainable equities to sustainable portfolios

Equities have been the asset of choice traditionally for SI. Here is where the greatest level of maturity has been reached. Yet even within some equity markets, such as emerging markets, the approach is still difficult to implement due to a greater scarcity of data and investable solutions that credibly incorporate the relevant features.

The trend is for investors to look for SI solutions beyond equities to ensure that their entire portfolio is structured in a way that incorporates ESG considerations. Each asset class presents opportunities, but also limitations that investors must keep in mind.

Overall, equities and fixed income lend themselves well to SI. Hedge funds and private markets exhibit a number of implementation hurdles, but interest is growing. Commodity investments are often problematic from a sustainability perspective.
**Fixed Income**

SI considerations are just as important in the world of fixed income as they are for equities. In a sense, ESG risk analysis, with its emphasis on protecting portfolio downside, is especially well suited for integration in fixed income investing. The corporate failure and associated bond defaults that have taken place due to poor corporate governance in recent years are reminders of the usefulness of such criteria.

For corporate issuers, the same SI criteria that are relevant for a company’s stock can be applied to its debt (exclusion and integration approaches). How one judges sovereign debt securities, however, is less well established. Still, there are some straightforward examples of exclusion criteria that could help screen out certain governments, such as: military conflict; human rights track record; access to healthcare, clean water, education and other basic needs; income inequality; and the health of the environment.

Fixed income is well suited to allow investors to have an impact with their portfolios (see impact investing on pg. 18). An interesting development is the emergence of a market for green bonds (see box at right), which now, beyond traditional multilateral issuers, also includes a growing amount of corporate issuance.

Overall, while fixed income SI is by no means as developed as it is for equities, the growing number of dedicated investment managers and the emergence of new segments of the bond market mean that ESG investors can confidently include the asset class in their portfolios.

**Commodities**

Commodities are a challenging asset class from an SI point of view. The production of physical commodities is often associated with negative environmental side effects, resulting from mining, drilling, land clearing, water use and generally higher levels of pollution. Another notable concern in mineral production and distribution is the violation of human rights in conflict areas. Finally, financial investments in commodities, which are often carried out through derivatives, have been blamed for increasing the price volatility of basic necessities, such as food and energy. Given these issues, how investors view these concerns will determine their inclination to include commodity investments as an asset class in an SI portfolio.

**Alternative Investments**

Alternative investments (AI) such as hedge funds and private markets share common characteristics that create a mixed appeal as vehicles to implement SI strategies. On one hand, both are inherently active strategies, which places fund managers in a strong position to incorporate the relevant criteria. However, both typically exhibit reduced transparency and reporting requirements, a significant factor enabling attractive risk-adjusted returns. For example, private equity financing is associated with reduced reporting and scrutiny on underlying companies compared to public listings. Implementing SI strategies and the associated transparency requirements may thus be challenging and costly to implement within AI, and may prove difficult to justify, notably in the case of fixed income strategies such as private debt.

**Hedge funds**

Hedge funds are heterogeneous in their investment strategies. Incorporating SI presents challenges from a performance and flexibility standpoint. Certain strategies, such as “equity hedge” (equity long-short), are better suited to incorporating SI criteria than others. Moreover, hedge...

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**Green bonds**

The emergence of the green bond market was originally spearheaded by the World Bank starting in 2008 to support lending for eligible projects that seek to mitigate climate change or help affected people adapt to it. Over the last two to three years, corporations have started issuing green bonds as well, using the earmarked proceeds to finance environmentally friendly projects. According to the Climate Bond Initiative, a non-governmental organization (NGO), the issuance of green bonds in 2014 reached nearly USD 36.6bn, while total issuance in 2013 amounted to USD 11bn. Despite significant growth, this market is still in its infancy.  

**Fig. 11: Green bond market taking off**

Annual and cumulative issuance in USD billion

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Issued Per Year (USD billion)</th>
<th>Cumulative Amount Outstanding (USD billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2008</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>2009</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>2010</td>
<td>30</td>
<td>60</td>
</tr>
<tr>
<td>2011</td>
<td>40</td>
<td>100</td>
</tr>
<tr>
<td>2012</td>
<td>50</td>
<td>150</td>
</tr>
<tr>
<td>2013</td>
<td>60</td>
<td>210</td>
</tr>
<tr>
<td>2014</td>
<td>70</td>
<td>280</td>
</tr>
</tbody>
</table>

Source: The Climate Bonds Initiative, as of 31 December 2014
funds may use techniques and instruments which can exert a controversial impact on target companies or market stability. While applying SI criteria is not inconsistent with hedge funds’ mandates, it introduces constraints on hedge funds’ opportunity set and may impact the flexibility of their approach. This explains why the industry has been relatively slow to embrace related strategies.

Private markets
Private markets funds finance mostly small- and medium-sized companies through private equity, private debt and real asset (such as private real estate and infrastructure) strategies. Some factors support the incorporation of SI in private markets. The multi-year time horizon of private markets coincides well with the long-term orientation of SI strategies. Moreover, fund managers proactively advise their companies and benefit from powerful corporate governance instruments such as a strong presence on the board, voting and veto rights and the use of specialized investment instruments (convertible debt and preferred shares). Their clout and expertise could support implementation of an SI framework.

However, various hurdles limit SI use in private markets, and the approach remains at an early stage of development and adoption. Some typical SI objectives might be incompatible with venture capital investments in dual use (military and civilian) technologies or in biotechnologies (such as stem cells or genetically modified organisms) that are still heavily debated. Moreover, leveraged buyouts can involve layoffs, which may be at odds with certain social goals.

Nevertheless, as discussed in Chapter 2, private markets funds have established themselves as a preferred financial structure for impact investing, with fund managers using their private markets toolbox to pursue extra-financial goals. Private markets thrive through innovation. They already offer investment solutions ranging from venture philanthropy to social impact funds and microfinance. These instruments offer interesting perspectives for investors willing to accept ESG constraints.
Real estate
Both physical and listed real estate offer a broad and fast growing SI universe. Property developers, investors and private as well as public property companies have shown strong and growing interest in such projects with a particular focus on low energy consumption (the highest energy standard being fully autonomous buildings). These types of real estate strategies offer advantages such as energy efficiency and thus lower costs, a higher building quality and an improved landlord image. Growing demand is underpinned by various global initiatives. For example, the Global Real Estate Sustainability Benchmark (GRESB) survey ranks funds and their managers into four categories, from those just starting to develop sustainability policies to top performers which have integrated the measurement and management of environmental key performance indicators into their investment processes. Moreover, building standards such as the Leadership in Energy and Environmental Design (LEED) have been created to increase transparency internationally.

Building an SI portfolio
In creating an SI portfolio, investors must keep in mind the same fundamentals of portfolio construction as with any traditional investment strategy. The objective of achieving an attractive risk and return mix based on a portfolio well diversified across different asset classes is key. To achieve this goal, we at UBS construct portfolios based on our long-term strategic asset allocations (SAAs), spreading capital across diverse assets such as equities, bonds, hedge funds, etc.

As the start of the chapter suggests, SI is not an asset class. It is an investment style that can be applied across a variety of asset classes. However, its availability, in particular for certain approaches, can still be limited in some asset classes. For example, impact investments are for now predominantly found in private equity or debt asset classes and less so in liquid equities. Investors must assess for each asset class whether solutions exist and whether they adequately incorporate the investor’s standards and specific preferences for SI.

If enough asset classes are investable using an SI approach, investors can follow the same fundamental principles for portfolio construction as for any conventional strategy. If not, some adjustments are needed.

How strictly to implement SI in a portfolio?
Investors can follow either a “pragmatic” or a “strict” approach. The “pragmatic” approach involves pursuing an optimal asset allocation target derived from the conventional investment process, investing with SI solutions in all asset classes for which such an implementation exists and relying on conventional solutions for the remaining asset classes. While the resulting portfolio is only partially invested in SI, the benefits of an optimal asset allocation are preserved.

A “strict” approach has a primary objective of being fully invested in SI and excludes asset classes which do not currently offer adequate solutions. This requires developing revised asset allocation guidelines built around the asset classes available for SI. The advantage is full consistency between the portfolio and the investor’s preferences and motivations for SI (see Chapter 1). However, one has to consider that, depending on the importance of the excluded asset classes, the resulting portfolio may be somewhat less diversified.

Liquid versus illiquid investments
Illiquid investments such as private equity generally lock up investors’ funds for several years and compensate investors by offering higher returns compared to their listed counterparts. These can be beneficial elements in a portfolio, but each investor has a limit regarding the amount of illiquid investments as dictated by liquidity needs.

This has implications for asset allocation and for the ability to implement certain SI strategies. The purest form of impact investing is currently found predominantly in illiquid asset classes such as private equity. Therefore, investors with high liquidity needs may find it difficult to embrace impact investing fully. They might need to focus on diluted versions of impact investing and more liquid styles such as integration or exclusion.

The corollary to this is that pursuing significant allocations to impact investments, for example, may result in a portfolio holding a large amount of illiquid asset classes.

Personalizing an SI strategy
There are several additional dimensions along which investors can personalize their strategy.

Sustainability themes that resonate with investors can be included in the portfolio. The choice here is whether to target exposure to themes, for example as satellite investments, to rely on preferred themes to select impact investing opportunities, or to ascertain that themes of interest are being reflected in the holdings of a specific third party manager. Such themes often focus on areas of scarcity and highlight solutions to alleviate it (see box on pg. 26). Note that sustainability-themed investment solutions do not always incorporate more general SI considerations.
The desired extent of shareholder engagement that invested assets facilitate is another consideration. Individual investors wishing to achieve a positive impact in liquid securities can do so through delegation of money management to a third party that is active in shareholder engagement.

Finally, an investor must decide how much active management should be integrated into the portfolio. While this decision does not pertain specifically to SI, it is relevant insofar as the majority of investment vehicles tend to be actively managed in this area. This has the benefit of enabling the investor to focus on managers who approach themes and engagement in their preferred way. Passive solutions such as exchange-traded funds are growing, however, driven by demand from institutional investors. They are quite popular as a means to target specific sustainability themes.

By carefully considering these options and choosing the right combination of the approaches we’ve highlighted in this report, investors can decide in what way their investments will help address the challenges to humanity presented in the introduction.
Executing your sustainable investing strategy

Sustainability-themed investing: Some examples

Environment

**Water scarcity:** Clean water supply is constrained by both the lack of infrastructure in emerging markets and aging water infrastructure in developed regions. Climate change, urbanization and industrial activities in emerging economies are also creating a negative impact on water supply. Water risk can affect business operations in any of the following ways: plant shut downs due to lack of water supply, and higher agricultural or basic material input costs if the supply chain is disrupted. Investing in water treatment, storage and distribution infrastructure are ways to alleviate water scarcity. Investments in more efficient irrigation technology, as well as desalination projects, can also be considered.

**Energy efficiency:** Energy efficiency improvements yield both energy savings and reduced carbon dioxide emissions. In recent years, stricter regulation with a view to protecting the environment and securing the supply of energy has been a powerful driver, boosting efficiencies in buildings, autos and power generation. Energy efficiency addresses a whole range of issues, such as the sought-after reduction in the use of fossil energy sources and the lack of storage technologies for renewable energies. Companies manufacturing energy-efficient equipment benefit from this trend.

**Food scarcity:** While providing humankind with enough food has been a challenge throughout the ages, rapid population and economic growth in emerging economies, combined with a shift toward higher protein, meat-based diets in these regions are a root cause for a stretched human food supply system. The two main channels to alleviate the problem are food waste reduction and increasing agricultural productivity. Agricultural productivity can be increased through more advanced equipment, better irrigation, fertilizer, and crop protection. Investors can look for companies active in these areas to gain exposure to the theme.

Social

**Labor standards and supply chain management:** The issue of labor standards within companies or in their supply chain has gained increased attention recently. It is of material relevance for companies as it relates to one of their key assets: human capital. Companies that fail to manage these issues properly may risk facing labor shortages and even strikes. They may also be at risk of losing their legitimacy with consumers and facing boycotts.

Governance

**Board diversity:** While achieving greater gender balance and minority representation in companies is often viewed as an issue of fairness, an economic case can be made as well. For instance, regarding diversity at the level of corporate boards, existing academic evidence indicates that greater diversity can improve how boards function and be associated with better financial performance.

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**Fig. 12: Increased efficiency can help alleviate environmental scarcity**

<table>
<thead>
<tr>
<th>Energy</th>
<th>Food</th>
<th>Water</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings</td>
<td>Fertilizers</td>
<td>Pipes, pumps and valves</td>
</tr>
<tr>
<td>Industrial processes</td>
<td>Crop protection</td>
<td>Utilities</td>
</tr>
<tr>
<td>Transportation</td>
<td>Farm equipment</td>
<td>Consumer applications</td>
</tr>
<tr>
<td>Information technology and electronics</td>
<td>Plantations and crop processing</td>
<td>Treatment services</td>
</tr>
<tr>
<td>Electricity production and transmission</td>
<td>Irrigation</td>
<td>Metering and testing equipment</td>
</tr>
</tbody>
</table>

Source: UBS
Outlook and conclusions

There are three steps in the revelation of any truth: in the first, it is ridiculed; in the second, resisted; in the third, it is considered self-evident.

Arthur Schopenhauer (1788–1860), philosopher

Sustainable investing has evolved from a niche discipline to an established field. It has now reached a level of maturity and acceptance fueled by changing societal expectations, a growing investor base, greater transparency and engagement by corporations, and an improved analytical infrastructure. It now capably fulfills the needs of multiple types of investors, while offering performance comparable to conventional approaches.

Investors approach SI for different reasons. Various solutions have emerged to satisfy this range of motivations – whether exclusion, integration or impact investing approaches. UBS CIO includes all of these approaches in its coherent framework. Investors must answer key questions to help guide their decisions before implementing such a strategy.

We believe that the SI movement is not only here to stay, but will also continue to grow faster than the investment industry as a whole. The shift in societal expectations currently underway is likely to extend beyond the next decade, driving a widespread adoption of SI principles throughout the investment community.

We expect this growth to be associated with an expansion in ESG integration within investment management, gradually embedding it within standard money management practices. We also think an expansion in the number and variety of impact investing options is likely, and that measuring social impact will become more established and effective.

For investors, this means SI will continue growing in appeal and sophistication, simplifying inclusion in diversified portfolios.
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Endnotes

2 SRI = Socially responsible investing, an expression often used in place of sustainable investing.

References


