

# Webinar: Are you climate aware?

## The economic case for climate-aware investing

Sustainable investing is a strategic priority for UBS Asset Management. We have over 20 years of experience in Sustainable Investing experience, and a dedicated framework for assessing climate-related risks in investment portfolios. We proudly take a leading position on environmental issues with a commitment that began back in 2000 when we became a part of the UN Global Compact and later became one of the first signatories to the UN Environment Programme. More recently, we have become active members of Climate Action 100+ initiative and are currently leading on 8 company engagements.

Amy Farrell, Senior Investment Specialist for the Sustainable and Impact Investing team, Francis Condon, Sustainable and Impact Investing Research Analyst, and Rodrigo Dupleich Ulloa, Senior Quantitative Analyst, discuss their framework for climate-aware passive equity investing.

### Key webinar takeaways

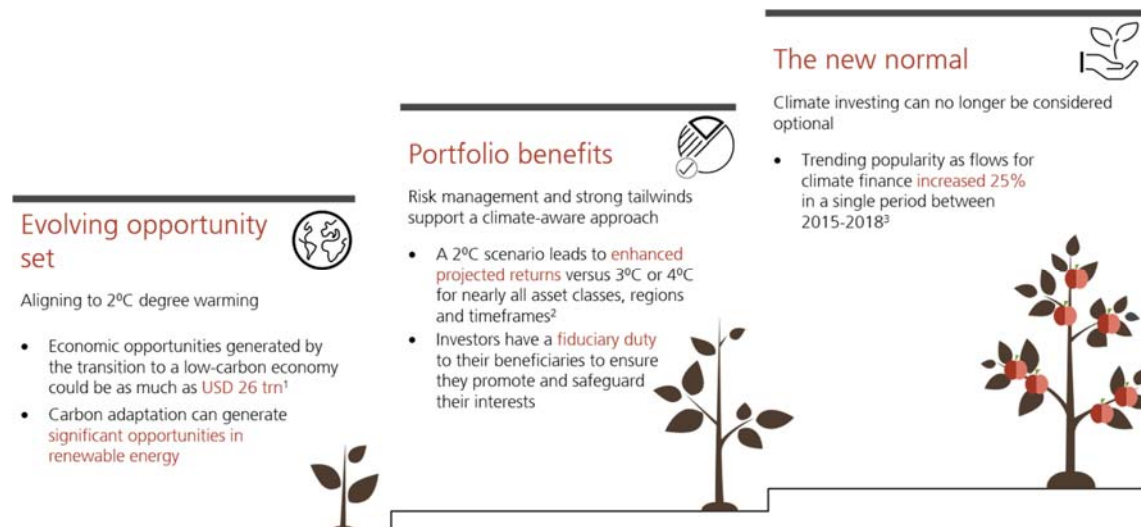
- Institutional investors globally have recognized the benefits of climate-smart investing and how it aligns with their fiduciary duties to safeguard their beneficiaries' investments by understanding the climate-related risks in their portfolios.
- An estimated \$26 trillion in economic opportunities will be generated by the transition to a low-carbon economy, including opportunities in renewable energy<sup>1</sup>
- Practically all sectors face specific climate-related opportunities and risks, and companies that focus on understanding how climate change affects their business models, are managing their carbon footprints, and communicating to investors benefit from demonstrating a reduced risk profile or exposure to demand for climate solutions

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<sup>1</sup> "The new climate economy," the 2018 report of the Global Commission on the Economy and Climate. September 2018.

Amy Farrell, Senior Investment Specialist, Sustainable and Impact Investing team

## Why investors want to support a climate smart transition



1 Source: <https://www.wri.org/blog-series/the-26-trillion-opportunity>

2 Source: Mercer "Investing in a time of climate change – the sequel", 2019

3 Source: <https://climatepolicyinitiative.org/publication/global-climate-finance-2019/>

We read every day in the news about the physical risks of climate change from weather-related events ranging from the devastating wildfires in the western part of the United States to the unprecedented Atlantic hurricane season this year. The effects of climate change are increasing.

There's been a dramatic increase in the attention paid by financial policymakers to sustainability issues. According to the Principles for Responsible Investment (PRI), there have now been over 730 hard and soft law policy revision across some 500 policy instruments which support, encourage or require investors to consider long-term value drivers, including ESG factors.<sup>1</sup>

The transition to a lower carbon global economy in order to help reduce the effects of climate change is expected to require about \$1 trillion of investments a year for the foreseeable future and will profoundly impact economies, and markets in coming years, according to some estimates. Investors are increasingly aware of public policy developments globally and as investment professionals, we need to incorporate the reality of climate change into our analysis in order to help efficiently allocate capital.




While we at UBS don't have all the answers, we would like to share with you our insights into integrating climate related risks and opportunities into fundamental and rules based research and provide you with a real example of a climate start smart strategy that we launched back in 2017.

<sup>1</sup>PRI responsible investment regulation database. Data as of June 2020.

## Francis Condon, Sustainable and Impact Investing Research Analyst

Climate change affects different sectors and companies in different kinds of ways. As investors, we need to understand the relevance, the materiality for each sector, and how individual companies are adapting to increase their resilience to the climate transition.

### Financial factors that may be affected by climate change

<b>Revenues</b>	Some companies (e.g. fossil fuel and high carbon intensity businesses) will see revenues under competitive pressure from low carbon technologies. Others (e.g. capital goods companies) will prosper by providing economically viable solutions that help solve for climate change	 IEA's Sustainable Development Scenario projects a 60% decline in coal use, a 6x increase in wind power and a 12x increase in solar power between 2018 and 2040
<b>Operating costs</b>	Any company that is emitting CO2 faces the risk that, at some stage, they are going to have to pay carbon tax or acquire permits as part of regulation with the potential to impact costs	
<b>Operating disruption</b>	Physical risks such as extreme heat causing drought and destroying crops or hurricanes affect the ability to produce	
<b>Environmental liabilities</b>	Operating infrastructures are not designed to meet new conditions emerging as a result of climate change	 In 2020, a Russian metal and mining company spilled 21,000 tonnes of diesel into a local river because high temperatures melted the permafrost, leading to failure of its storage tank
<b>Damage liabilities</b>	Assets which are not being managed with enough regard for a changing climate can lead to a social impact (e.g. people losing their homes)	
<b>Asset valuation</b>	Assets can be worth less or may become less economically attractive or viable as a result of the effects of climate change	
<b>Lower returns</b>	Higher incidences of extreme weather require reinsurance companies to pay out more, which affects overall returns	
<b>Strategy implementation</b>	How management steers business direction to align with climate transition can require trade offs and potentially lead to major consequences	 US electric utility company commits to 100% clean energy by 2050 spanning the retirement of coal-fired power by 2031 and the expiry of nuclear power station permits in 2045-47

We look to focus on the specific issues which are material to the individual companies we are considering for investments. Understanding the fundamentals of climate change and engaging on how companies are managing their key issues becomes part of the investment process. Assessment is the first step, looking at what issues are material to individual companies we are investing in. In many cases engagement is the second step, where we want to encourage positive change, but we also want to do it in a way that ideally unlocks alpha or reduces risk and that we can do in a meaningful timeframe. We may use the voting rights of our shares to help communicate our satisfaction with the rate of progress. In the review phase we look at the progress we have made with respect to climate change.

A case study that provides an example of our engagement process is a European oil and gas company. For fossil fuel companies, climate change creates a variety of risks, including to strategy, capital allocation, operating revenues, asset valuation, and returns. We began engaging with this company on climate related issues in 2018 and stepped up to become a co-lead of the Climate Action 100+ coalition. In April 2019, the company published a joint statement with UBS and other co-leads making commitments on adapting to climate change, based on our engagement with the company. Earlier this year they followed up with a climate roadmap for reducing greenhouse gas emissions and lowering overall carbon intensity while increasing their investments in renewables. The progress in this engagement has helped the company in its climate transition and gives investors much greater insight into the how the company is managing these risks.

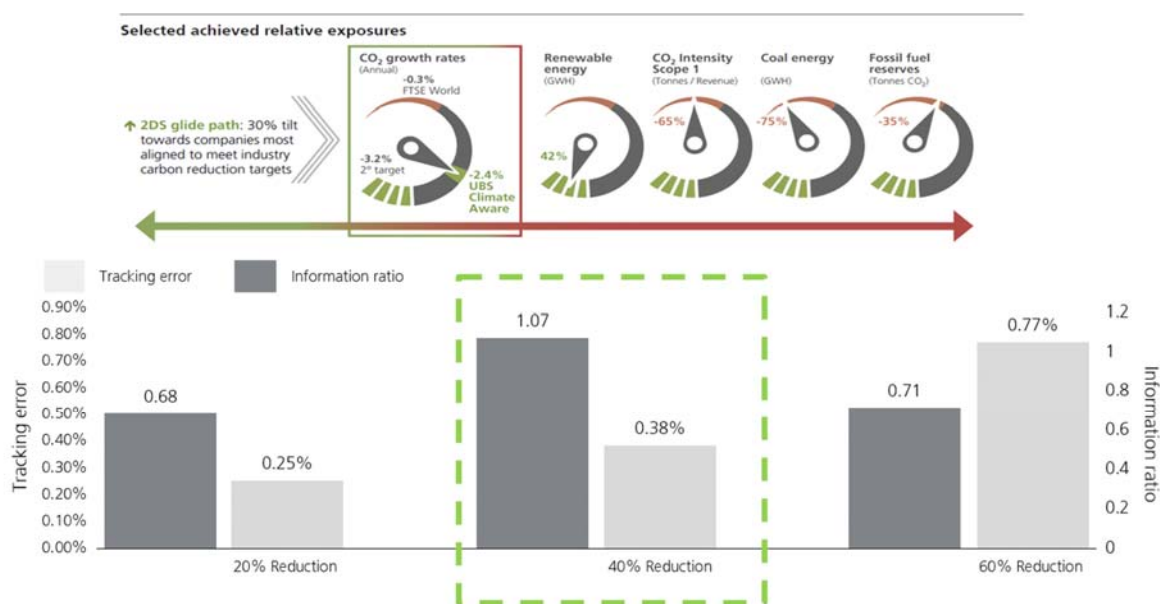
Our engagement process also applies to passive strategies where we are taking client specified factors and metrics to create efficient rules-based portfolios. One such is the UBS Climate Aware strategy, which applies ‘tilts’ to an equity index away from companies we believe are less likely to be in line with the low carbon economy and towards companies we see as most aligned to meet industry carbon reduction targets.

## Rodrigo Dupleich Ulloa, Senior Quantitative Analyst

Over the last 10 years there has been a lot of progress on how companies can estimate and register their carbon emissions, and the reporting framework divides emissions into three types. Scope 1, covers the emissions from direct company operations. Scope 2 is considered indirect emissions, generated in the production of electricity, heat or energy consumed by the institution. Scope 3 has been getting more attention in the last three years, and covers emissions that occur as a consequence of activities of the institution, but from sources not owned or controlled by the institution. This could include emissions produced within the institution’s supply chain. Over the years, we have seen different data providers capture emissions data which can be used in informing investment decisions. Different providers develop their own methodologies in order to estimate emissions for companies that do not report and understanding data quality is critical to a good systematic investment process.

Emissions tend to be concentrated in specific industry sectors and geographic regions, and when we construct our passive UBS-AM Climate Aware portfolio, we look at emissions as a multi-dimensional issue. We have a framework that aims to measure the efforts that companies are putting into mitigation, adaptation and transmission. Mitigation is the effort to reduce their carbon footprint at Scopes 1, 2 and 3. Adaptation is the development and use of innovative technologies to reduce emissions or use more renewable energy. Transition focuses on a company’s efforts at transitioning to a lower-carbon future and their alignment with the glidepath to conforming with the goal of limiting temperature increases to 2 degrees C by 2100.

### Tilting ESG and carbon factors by building carbon aware portfolios with a low tracking error



Source: UBS Asset Management, MSCI, RIMES.

Note: These figures refer to the past. Performance figures are gross of fees and transaction costs. Past performance is not a reliable indicator of future results. Historical tracking error is not a guide to the future. Data from 31 December 2011 through November 30 2019. (earliest date for which data is available) to 29 November 2019. UBS Climate Aware Fund was launched in January 2019, data prior to that is simulated. Two-Way Turnover includes index turnover incurred at and between index reviews and dividend yield. We aim to reduce turnover in index equity portfolios, and have been able to reduce turnover in the market cap index equity portfolios we manage vs. the underlying index by 40-60% p.a. historically. Excess return is geometric p.a. - CO<sub>2</sub> Metric Tons includes Scope 1 and Scope 2 emissions. Carbon intensity and Carbon emissions are averaged over the entire period.

When we build up strategies in UBS asset management, we begin by analyzing a portfolio in terms of exposures. We are able to show different potential exposures of our strategies with respect to their benchmarks. For example, we know that reducing the portfolio's carbon footprint by 20%, or 40%, will likely result in a predictable potential tracking error and information ratio.

The UBS-AM Climate Aware framework seeks to give investors the ability to have a lower carbon footprint than the index, increased exposure to upside opportunity sets in renewables, and relatively low tracking error alongside the benefit of a targeted stewardship approach including voting and engagement

## Q&A

Which benchmarks can the Climate Aware strategy be implemented against?

(Rodrigo) The methodologies and the data availability make it most feasible to implement on global benchmarks, like MSCI World or FTSE Developed and also on some regional benchmarks, or in the case of the US on liquid benchmarks such as the MSCI US. It becomes more challenging on small benchmarks that have a small number of constituents, for example, where you have less degree of freedom to build up the exposures of the portfolio. If one wanted to use the Russell 1000 or Russell 3000 we see issues there because some of the small caps tend not to disclose data, so data providers have to estimate more of the data on the small caps, increasing the uncertainty.

With regard to engagement, why should companies, be willing to engage with you? And, how do you actually build up pressure on these companies?

(Francis) It's a good question, and one we asked ourselves when we created the climate engagement program. I think one thing we bring to the discussion as a large asset manager is scale. We're talking to companies on behalf of all of our equity positions. We also bring fixed income into the discussions when appropriate, so we bring our scale.

We are also able to take part in collaboration, and this is when we became very interested and very involved in the Climate Action 100+ initiative. It has brought even more leverage, bringing investors together to speak with one voice, in coalitions with additional attention and focus.

And we take the progress of engagements into account when it comes to voting. We have made it clear to some companies that we have voted for climate related shareholder resolutions, and against management, in order to communicate that we are noticing their lack of progress.

How much tracking error, and active risk does an investor need to take in reducing my carbon footprint and is there a tradeoff between reducing the carbon footprint of a portfolio and your role of being a good fiduciary?

(Rodrigo) I think the starting point in constructing a carbon aware portfolio is to choose the benchmark we aim to decarbonize. The next question will be, what is the tracking error that you can afford in order to decarbonize that portfolio, and usually that parameter will give you the level of that you can set as your carbon reduction target.

On the second question in terms of the tradeoffs between carbon reduction and fulfilling fiduciary duty, there are a couple of aspects to take into account. For example, some clients believe exclusion is the right approach to decarbonize a portfolio, removing the worst emitters. It may be a valid approach, but it may be less efficient because removing a large segment of the oil and gas industry might lead to a slightly higher tracking error compared to our approach of tilting away from these high emitters.

We've observed increasing correlation among the data providers on climate data like emissions, but we're curious why reported data would only show 92% correlation between MSCI and Trucost. Why wouldn't correlation be 100% if it's directly reported. Are the data and analytics robust enough to attribute to sustainable investing decision making? And could you address the backward looking aspect of the data?

(Francis) My understanding on correlation between data providers is that while there's a lot of reported data out there, not all reported data is equal. Some companies report on different boundaries, some companies report on different scopes, and the data providers use different methodologies and algorithms for cleaning up the reported data, which is why the correlation doesn't quite get to 100%.

In terms of the attribution. I think we're still in the early days of being able attribute a share price move or evaluation difference wholly to sustainable investing. And this is why we view it as part of the mix. We do have sustainability focused products that look for a specific sustainability benefit, alongside financial returns. But in our integration of ESG, we are looking to bring

together the whole discussion of fundamental financial analysis and ESG factors into our understanding of valuation and of returns.

The question of data being backward looking, it's a very good question and very much at the heart of discussions around where data needs to go. Where we all really want to get to is, what does a company commit to, how do they progress, what is their trajectory towards the 1.5 degrees or 2 degrees pathway, and can they get to net zero in 2050? At the moment, what we have is a number of companies who have put out targets and ambitions, across a wide range of carbon intensive sectors. There are methodologies that have been created to help understand how much these decarbonization plans align with a 2 degree or 1.5 degree pathway. The challenge is that there are still not enough of these companies but it provides our best, forward looking, guiding star as to whether companies and portfolios can make it to net zero

(Rodrigo) On the issue of non-correlation of data we have seen an increase in companies disclosing their carbon data. Still, it's only around 40% of our benchmark, but compared to 10 years ago that level has been increasing, and we believe the correlation between data providers will rise too. A second component of data variance is companies may have different cycles of reporting the data, and also different venues in which they report their data. And that leads to data providers capturing data at different points in time which causes some discrepancies.

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