UBS House View

Monthly Letter

Chief Investment Office WM
14 December 2017

Social responsibility

The investment world has changed. There is now solid evidence that incorporating social responsibility into investment decisions does not sacrifice returns.

More options

A broader and deeper sustainable investment market means investors can have a diversified portfolio of sustainable assets, from green bonds to funds that buy stock in firms with strong environmental, social, and governance records.

New activism

With more data available, investors are better able to engage with businesses to drive positive change as well as excess returns.

Asset allocation

We are opening an overweight in a basket of four high-yielding emerging market (EM) currencies versus a set of lower-yielding currencies, and an overweight in EM local currency bonds against high grade bonds.

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Sustainable performance

The end of the year is a time to reflect on past successes and plan for the months to come. Regular readers will know that we took our portfolio management responsibilities seriously, held some contrarian views, and added value overall with our market calls. Yet the question of our social responsibility as portfolio managers is coming up more and more. For 20 years I answered that question by citing the influential article, "The Social Responsibility of Business is to Increase its Profits," by Nobel prize-winning economist Milton Friedman.

But I now believe investors *must* consider social responsibility when making investments. This is not because I would advocate mixing investing and philanthropy: there is little room for emotion in investment decisions. Rather it's because the investment world has changed. A more transparent world means that environmental, social, and governance (ESG) factors are now more easily measured and are increasingly internalized into market prices. There is now strong evidence that thinking about social responsibility as part of the investment decision-making process does not sacrifice returns. Indeed, it can actually help de-risk, diversify, and enhance them.

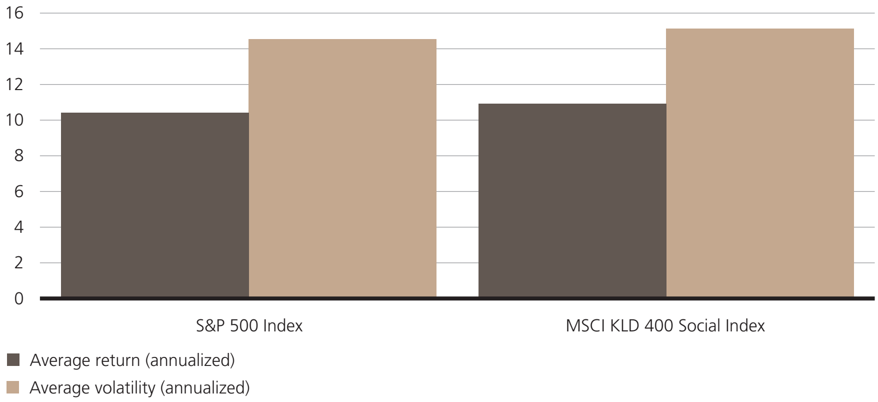
The sustainable investment market has broadened and deepened, particularly into fixed income instruments, such as green bonds. This means that private investors can now achieve the goals of traditional diversified portfolios with sustainable assets. Sustainable investing can now move from the "satellite" to the "core" of an investor's portfolio.

We are striving to be the leader in sustainability and sustainable investing (SI). You can read more about our efforts on our page UBS and Society.

In our tactical asset allocation this month, we remain overweight in global equities, a position that remains supported by strong global economic data. In addition, we are opening two new positions: an overweight in a basket of four high-yielding emerging market currencies (Brazilian real, Indian rupee, Turkish lira, Russian ruble) against a set of four pro-cyclical lower yielding counterparts (Australian dollar, Hungarian forint, Norwegian krone, Taiwan dollar), and an overweight in EM local currency bonds against high grade bonds.

Fig. 1: Sustainable and conventional equity indexes show similar performance

Comparison of S&P 500 Index and MSCI KLD 400 Social Index (i.e. sustainability equivalent of S&P 500), April 1990 – June 2016, in %



Source: Bloomberg Finance L.P., UBS WM CIO, as of June 2016

How the sustainable world has changed

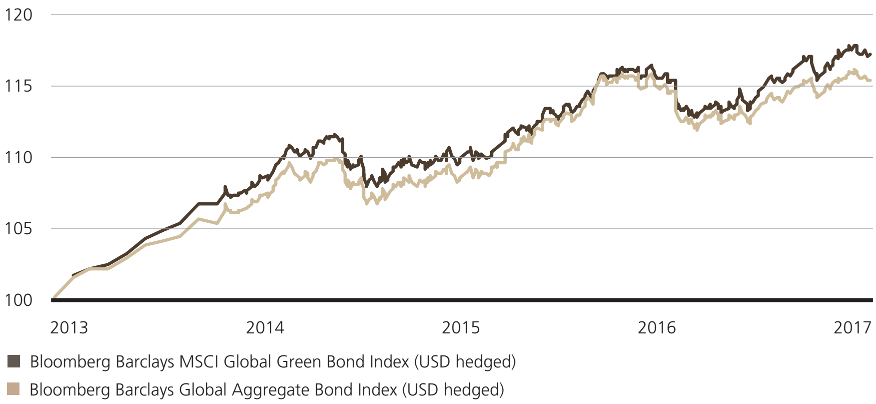
Sustainable investing strategies returns are comparable or superior to traditional investment strategies.

Some sustainable investing strategies and conventional strategies show similar performance.

The average return of the MSCI KLD 400 Social Index, which tracks sustainable firms, has matched the S&P 500 on risk and return criteria (Fig.1). The Bloomberg Barclays MSCI Green Bond Index, which measures fixed income instruments whose proceeds are earmarked for projects with environmental value, slightly outperformed the Bloomberg Barclays Global Aggregate between December 2013 and October 2017, with a return of around 17% compared with 15% (Fig. 2). And the bonds of the International Bank for Reconstruction and Development, the main lending arm of the World Bank, offer a yield advantage of 13 to 20 basis points over equivalent US Treasuries across the curve.

Fig. 2: Sustainable bonds and conventional indexes also show similar performance

Comparison of Bloomberg Barclays MSCI Green Bond Index and Bloomberg Barclays Global Aggregate Bond Index, December 2013 – October 2017, in %



Source: Bloomberg Finance L.P., UBS WM CIO, as of October 2017

More than two-thirds of asset owners say that explicitly integrating ESG criteria into their decision-making process has significantly improved returns.

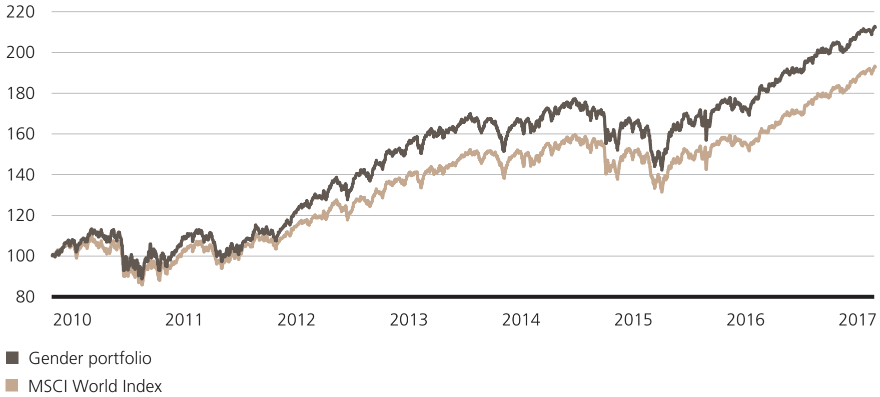
Roughly 90% of the 2,200 peer-reviewed academic studies on the relationship between sustainability and financial performance found either a positive or neutral correlation. More than two-thirds of asset owners say that explicitly integrating ESG criteria into their decision-making process has significantly improved returns. Such ESG integration strategies have been growing at 17% per year and are now used with nearly half of sustainable investments[1].

Gender diversity serves to a certain degree as a proxy for good corporate governance practices.

In our view, gender diversity serves to a certain degree as a proxy for good corporate governance practices (Fig. 3). We have found that firms with women in at least two board seats or 20% of leadership positions were more profitable across various metrics relative to their less gender-diverse peers. Our gender-focused company basket outperformed the MSCI World Index by 2% a year on average between 2011 to November 2017.

Fig. 3: Gender-diversity investing strategies tend to outperform

Annual performance of gender-focused portfolio versus world equity market, in %



Note: Model assumption: At least 2 women at the board level or 20% women in executive management
Source: Bloomberg Finance L.P., UBS WM CIO, as of November 2017

For more on our research on gender diversity, you can read our report "Gender Diversity Matters."

Externalities can now be measured and are increasingly internalized into market prices.

Increasing connectivity and big data have made our world more transparent than before.

Increasing connectivity and big data have made our world more transparent than before. As a result, it's getting easier to measure what previously would have been considered externalities. For instance, firms such as Carbon Delta are able to quantify an individual company's climate change risk, and calculate its potential valuation impact for investors.

This has two major consequences, both of which mean that ESG considerations are becoming increasingly important in investment processes:

The first is that companies or sectors found to be abusing the public trust face much greater legal and regulatory scrutiny – and potentially significant costs. Aggregate fines and settlements in the US hit USD 180bn in 2014 – a more-than-threefold increase in just five years. And the world's top 20 banks were hit with conduct charges of GBP 264bn (USD 353bn) in 2012–2016, nearly one-third more than the total for 2008–2012, according to the Conduct Cost Project's Research Foundation. Markets are growing aware of this risk, so investors who fail to integrate ESG considerations into their investment process put themselves at greater risk.

[1] "From 'why' to 'why not': Sustainable investing as the new normal", McKinsey & Co. October 2017

The second consequence is that, armed with this type of data, investors are in a much stronger position to engage more effectively with businesses to drive positive social, environmental, and therefore, financial, outcomes:

- Partly as a result of pressure from sustainability-focused investors, Mexico-listed multinational cement producer Cemex published 18 medium-term sustainability targets linked to atmospheric emissions, use of alternative fuels, sales derived from sustainable products and materials, labor safety, and responsible supply chains.[2]

- In May 2014, Colgate-Palmolive explicitly acknowledged the important influence of outside stakeholders in its decision to commit to reduce carbon emissions on an absolute basis by 25% relative to 2002 levels by 2020, and by 50% by 2050.[3]

- Successful shareholder engagement on ESG factors has been shown to deliver positive cumulative excess returns of around 7.1% in the year subsequent to shareholders and management reaching agreement.[4]

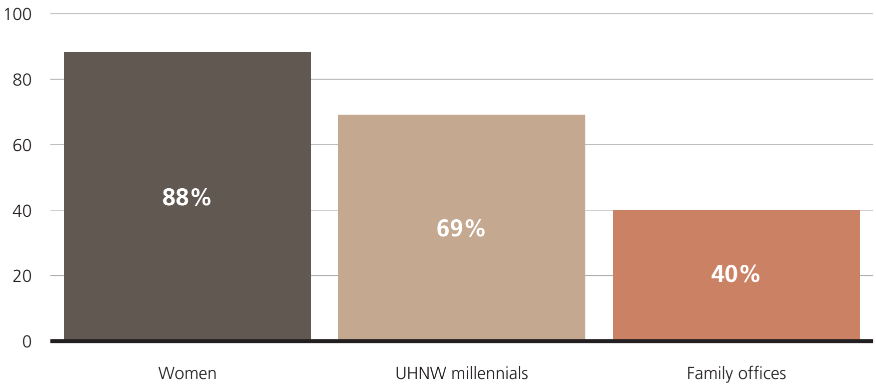
The sustainable investing market has broadened and deepened.

Despite large appetite for sustainable investments, assets managed to ESG objectives represent less than 10% of global household wealth.

The appetite for sustainable investments is large. According to UBS and Oppenheimer Funds surveys with Campden Wealth, around 88% of women surveyed say they want to align their investments with their social values, along with 69% of UHNW millennials, and 40% of family offices (Fig. 4). Despite this impressive apparent appetite, assets managed to ESG objectives represent just 8% of the overall global household wealth of USD 280trn.

Fig. 4: Interest in sustainable investing is growing

Percentage of people surveyed that want to align their investments with their social values, in %



Source: UBS/Campden Wealth Global Family Office Report 2017,
Oppenheimer Funds/Campden Wealth Research 2015, as of December 2017

It is now possible to construct fully diversified sustainable portfolios that should offer comparable returns, risk, and liquidity to traditional portfolios.

The gap between interest and reality is, in my view, due to a lack of sustainable options for the kinds of multi-asset portfolios at the core of our House View investment process. However, the SI market has now broadened and deepened sufficiently that investors can construct fully diversified portfolios that should offer comparable returns, risk, and liquidity to traditional portfolios while considering their impact on society and the environment.

[2] "EOS Case Study: Cemex", Hermes Investment Management, August 2017

[3] "Evaluating the impact of shareholder engagement in public equity investing", Impact of Equity Engagement (IE2) initiative, November 2014

[4] "Active Ownership", Dimson et al., The Review of Financial Studies, August 2015.

SI is therefore ready to go mainstream. I would like to outline some of the sustainable investing exposures we believe can be used to construct portfolios with a similar risk-return profile to traditional portfolios:

Bonds

MDBs play a critical role in providing development where it's needed most.

- Multilateral development bank (MDB) bonds: MDBs like the World Bank Group play a critical role in providing development where it's needed most. In recent years, they have financed: irrigation services for more than two million hectares of land; access to an improved water source for 42 million people; and the reduction of 588 million tons of CO2-equivalent emissions annually. Bonds issued by these banks are typically AAA-rated, are backed by multiple sovereign governments, have never defaulted, and can be considered, in our view, comparable to high grade bonds such as US Treasuries.

Green bonds are one of the fastest-growing segments of the fixed income market.

- Green bonds: One of the fastest-growing segments of the fixed income market, green bonds are conventional fixed income instruments in which the proceeds are earmarked specifically for projects with environmental value. You can invest, for example, in bonds that target renewable energy, energy efficiency, sustainable waste management, sustainable land use, biodiversity conservation, clean transportation, and clean water/drinking water. We believe you could expect diversified green bond exposure to generate returns comparable to a mix of traditional high grade and investment grade corporate bonds.

Equities

- Thematic: By investing in companies trying to address the world's environmental and social challenges, investors can both benefit from and support the solutions such companies offer. Our longer-term investment themes include numerous companies involved, for instance, in expanding water infrastructure, providing renewable energy, and delivering healthcare equipment.

- ESG Leaders: Leaders in ESG standards are those companies that not only avoid major adverse effects on society and the environment, but also try to influence their wider industry in improving sustainability standards. Many of these firms view ESG factors as opportunities to improve financial returns.

- ESG Improvers: Investors can help reward progress on social and environmental issues by tilting allocations toward companies that have significantly improved in these areas in recent months and years, and protect their portfolios from companies whose ESG performance has deteriorated.

Fund managers can engage with company management to encourage ESG improvements.

- ESG engagement: Fund managers can also engage with company management to encourage ESG improvements. This can have a direct impact. For example, according to data compiled and analyzed by Ceres, of 779 climate-friendly shareholder proposals filed from 2013 to 2017, 36% were adopted without the need for a vote after investors and the companies in question agreed that more needed to be done to reduce their carbon footprint.

While not part of our liquid portfolio building blocks, private equity can play an important part in a diversified portfolio. This is no different in the impact investing subset of private equity, which encompasses investments where clear intent and evidence of impact can be demonstrated. These strategies tend to focus on fast-growing themes such as education technology, healthcare, renewable energy and clean-tech, and building responsible businesses in developing countries.

As is the case in liquid markets, the quality and quantity of the investment universe continues to develop and has reached the point where we now believe that impact investing solutions can deliver returns equivalent to traditional PE strategies.

Investors should consider social responsibility issues in their investment decision-making process.

Many investors are passionate about SI and philanthropy, and are leading the drive to integrate ESG criteria into mainstream investment analysis. But the broadening and deepening of the SI universe, the improvements in measuring societal and environmental impacts, and the long-term track record of sustainable portfolios mean that investors should consider social responsibility issues in their investment decision-making process.

Asset allocation

We are opening an overweight in a basket of four high-yielding emerging market currencies versus a set of lower-yielding currencies.

We are opening two new positions in our tactical asset allocation this month. First, we are adding an overweight in a basket of four high-yielding emerging market (EM) currencies (the Brazilian real [BRL], Indian rupee [INR], Turkish lira [TRY], and Russian ruble [RUB]) against a set of four pro-cyclical lower-yielding counterparts (the Australian dollar [AUD], Hungarian forint [HUF], Norwegian krone [NOK], and Taiwan dollar [TWD]).

The main appeal of this trade is the EM basket's attractive carry of around 7%. We have held back from exploiting this carry in recent months because we anticipated a US dollar (USD) boost – from tax reform and rising expectations for Federal Reserve tightening – to undermine EM currencies. We now believe this Trump trade in the USD has largely played out, and this makes it safer to harvest the EM carry. We selected the opposing currency pairs on the basis of their likelihood to display similar price movements in the event of potential upsets, such as a sharp swing in oil prices or a broad decline in global risk appetites. (For example, the AUD and NOK are exposed to commodity price moves, as are the BRL and RUB.)

We are opening an overweight in a diversified basket of EM local currency bonds against high grade bonds.

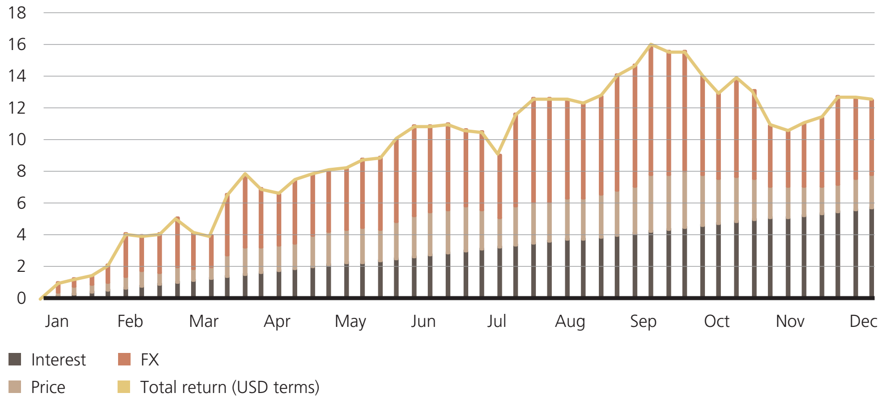
Second, we are opening an overweight in a diversified basket of EM local currency bonds against high grade bonds. EM local currency bonds offer an attractive yield advantage of 3.6 percentage points (ppt) against US high grade bonds, slightly above the average premium of 3.5 ppt since 2003. We anticipate limited upward pressure on EM local currency bond yields, given the easing bias we see in EM monetary policy. This contrasts with our forecast for gradually rising yields in advanced economies like the US (Fig. 5).

We remain overweight global equities.

We also retain several positions from previous months. We are overweight global equities. Over the past month, global stocks benefited from rising expectations of corporate tax cuts in the US. Global equities got an extra push from the strength of the financial services sector, after an agreement on Basel IV rules that give banks longer to adopt rules on how they calculate capital for trading businesses,

Fig. 5: EM local currency bond returns are recovering after a setback earlier this year

Total return of GBI-EM Global Diversified year-to-date, including return components (interest, price, and FX), in %



Source: JP Morgan, UBS WM CIO, as of 11 December 2017 as well as hopes for looser regulation of US banks. More broadly, we believe that stocks remain underpinned by the health of the global economy. In November, the global manufacturing Purchasing Managers' Index (PMI) rose to 54.0 from 53.5 in October.

We remain underweight euro high yield credit.

We remain underweight euro high yield credit. This was the weakest major global credit market over the past month, with a roughly 40 basis point widening in spreads. While there was no specific catalyst for the move, the market, we believe, is coming around to our view that this asset class is overvalued. The yield to maturity of 3.1% – versus an all-time low of 2.8% in early November – still looks too low and we expect the asset class to further underperform relative to equities.

We remain overweight Eurozone equities versus UK stocks.

The outlook for Eurozone equities is brighter, and we are overweight versus UK stocks. Eurozone GDP growth is expanding at its fastest pace in six years, with the forward-looking survey data pointing to continued strength: the composite PMI rose to 57.5 in November from 56 in October. This contrasts with the outlook for the UK, where we expect higher inflation, which has hit 3.1%, to undermine consumer spending power.

We remain underweight the NOK versus the SEK.

In currencies, we are underweight the NOK versus the Swedish krona (SEK). Norway's inflation started the year at 2.8% but was just 1.1% in November, and a deteriorating housing market should drag on consumer confidence. By contrast, the Swedish economy is gathering momentum, with GDP growing by 2.9% in the third quarter relative to 1.9% for the first quarter and 2.7% in the second. With inflation hitting the central bank's target, we see the Riksbank shifting in a more hawkish direction.

We remain underweight the USD versus the CAD.

Finally, we are underweight the USD versus the Canadian dollar (CAD). While the US currency is set to face headwinds from the twin fiscal and current account deficits, the CAD is likely to benefit from the recovery in the Canadian economy, which is now running above potential.

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UBS Investor Forum Insights

At our final Investor Forum of the year, participants discussed the main risks for 2018:

- Delegates argued that a US recession was the main risk for the coming year, although the probability of this occurring remains low.
- China's rising debt burden emerged as a key concern.
- In terms of political risks, participants identified tensions in the Middle East and Brexit talks as among the principle worries.

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Version 07/2017.