For marketing purposes
For professional / qualified / institutional clients and investors, US retail clients and prospects

Sustainable Index Investing

at UBS Asset Management

Executive Summary

- Index strategies provide many opportunities for sustainable investors, but they also face unique challenges due to their broad exposure to companies that may have breached principles of responsible business conduct.
- As a leader in sustainable investing, UBS Asset Management is committed to directing capital towards responsible companies and developing sustainable index solutions that reduce exposure to companies with business conduct risks.
- Through a risk-based approach to integration and stewardship, UBS Asset Management pursues a proactive approach to identifying and mitigating these risks across its index strategies.

> "UBS-AM provides clients with opportunities to significantly reduce sustainability risks in their passive investment strategies."

Introduction

UBS is conscious that the activities and decisions of our clients can have substantial impacts on society. That is one of the reasons we strive to incorporate ESG (Environmental, Social and Governance) impacts into the products and services we provide to clients and partner with them to help mobilize capital toward achieving the United Nations Sustainable Development Goals and the orderly transition to a low-carbon economy.[1] Within UBS Asset Management (UBS-AM), this commitment has meant a focus on integrating ESG factors in our fundamental research process across active strategies. For our passive and rules-based strategies, sustainable investing has emerged as a key requirement for many clients, and UBS-AM has worked with its clients and index providers to develop a wide range of sustainable index strategies.

While representing an area of opportunity for sustainable investing, passive and index strategies more generally face unique challenges from a sustainability perspective. Given their broad scope in holding the constituents of an underlying index, passive strategies can expose investors to companies that may have breached environmental or human rights standards, and it may be more challenging for passive investors to avoid these companies in index linked portfolios. This publication explains steps UBS-AM is taking to address this risk in its passive offerings in light of the OECD's recommendations for institutional investors.[2] Specifically, by developing sustainable index offerings, UBS-AM provides clients with opportunities to significantly reduce sustainability risks in their passive investment strategies. Moreover, through risk-based assessments to prioritize voting and engagement activities, UBS-AM pursues stewardship outcomes that seek to mitigate responsible business conduct risks across its holdings in passive portfolios.

[1] Refer to the Annual Report 2020, available from 5 March 2021 under "Annual reporting" at ubs.com/investors, for more information on UBS's sustainable finance activities in 2020.
[2] See OECD (2017) "Responsible business conduct for institutional investors: Key considerations for due diligence under OECD Guidelines for Multinational Enterprises."

> "It is estimated that seven out of the ten largest global funds are now index trackers."

The growth of passive and the sustainability challenges of passive strategies

Arguably the most significant secular trend within asset management over the past decade has been the shift from active to passive strategies. Index oriented strategies have experienced significant growth globally, both in terms of assets under management but also in terms of index funds gaining market share away from active funds. During this timeframe, the share of index assets within the asset management industry as a proportion of total assets managed globally has doubled to c. 20% (c. USD 18 trillion index AUM globally) and is forecast to reach 30% by 2025 (source: Boston Consulting Group, data as of July 2020). It is estimated that seven out of the ten largest global funds are now index trackers. UBS-AM is currently the second largest European index player with USD 466 billion index assets under management (AUM) (data as at 31 December 2020) and has experienced strong growth in recent years.

Index strategies have several unique characteristics compared to active strategies. Unlike active strategies, passive index strategies generally replicate an existing and published index calculated by a third-party index provider. In order to avoid conflicts of interest, these indices are required for regulatory and/or best practice reasons to be calculated by index providers and maintained independently of the asset managers. Index providers publish the rules and determine the constituent companies and their weightings within the indices, while asset managers then create investment vehicles for clients, such as ETFs and pooled funds which adjust the weights of portfolios in order to track the index as closely and efficiently as possible. Many index and ETF products require "full replication" of the index which entails holding every constituent at the same weight as in the reference index. All index products aim to keep the financial performance deviations or "tracking error" to a minimum vs. the relevant index.

While index strategies offer investors a low-cost means of diversifying risk and gaining exposure to broad market returns, they pose unique challenges from a sustainability perspective. Most fundamentally, because of the broad set of constituents that make up an index, passive strategies are more likely than active strategies to expose investors to companies that have significant controversies and are in violation of basic principles of responsible business conduct (RBC).[3] Furthermore, unlike active investors who may choose to divest from such companies where RBC issues may arise, index investors are usually required to maintain holdings close to the underlying index weights, and consequently they may indirectly be linked to the RBC violations of those companies in their passive portfolios.

In its paper on due diligence practices for institutional investors, the OECD provides several recommendations that have implications for passive managers to address these challenges. First, passive investment managers can work with index providers to develop sustainable index strategies that reduce exposure to companies with RBC risks. By tracking more sustainable indices, passive investors can replicate the constituents of the underlying benchmarks while nonetheless significantly reducing their exposure to RBC risks. Second, passive managers should conduct a risk-based approach across passive holdings to identify issues where business conduct issues may have occurred. And finally and perhaps most importantly, passive managers should mitigate these risks through active stewardship practices and regularly report on the results of these activities.[4]

[3] The principles of Responsible Business Conduct are outlined in the OECD Guidelines for Multinational Enterprises and cover the areas of responsible business including human rights, employment and industrial relations, environment, anti-bribery, consumer interests, science and technology, competition and taxation. See http://mneguidelines.oecd.org/mneguidelines/

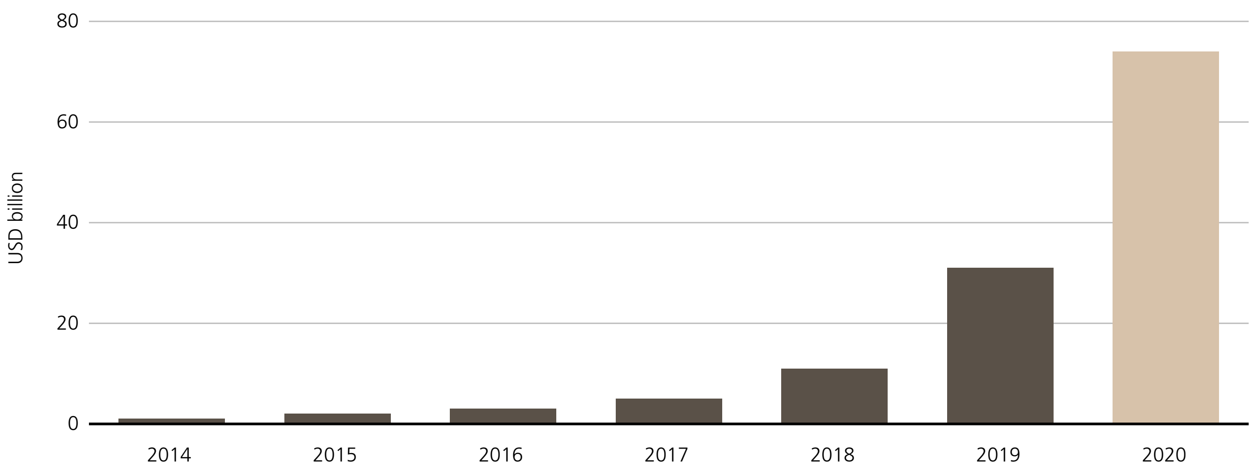
[4] See OECD (2017) Responsible business conduct for institutional investors: Key considerations for due diligence under OPECD Guidelines for Multinational Enterprises," pp. 31-33, 42.

Developing sustainable Index offerings for clients

For UBS-AM, developing and promoting sustainable index alternatives for clients has become a priority, and our sustainable index offerings allow investors to substitute traditional index strategies for alternatives with significantly lower sustainability risks. In recent years, UBS-AM has witnessed a significant increase in the assets invested in sustainable passive products. Since 2017, UBS-AM's assets in sustainable index strategies have grown from USD 4 billion to USD 73 billion (data as at 31 December 2020). UBS-AM is now the second largest provider of sustainable ETFs in Europe with a total of over USD 21.9 billion in sustainable ETF AUM.

This growth has been driven by a range of passive and ETF strategies that allow investors to achieve returns in line with the underlying index, while significantly improving the sustainability profile of the portfolio and thereby reducing exposure to RBC risks. One of the most recognized approaches across UBS-AM's ETF offerings pursues a "best in class" approach of investing in only the most sustainable companies within their respective index sectors. The UBS MSCI SRI Leaders ETFs, for example, invest only in the top 25% sustainability performers within each industry group across a wide range of geographic benchmarks. In addition,

UBS-AM sustainable index AUM (in USD billion)



Source: UBS Asset Management. Data as at 31 December 2020.

these index offerings apply exclusions of companies that are in violation of the United Nations Global Compact.[5] These offerings provide investors with a cost-efficient means of maintaining returns in line with the underlying index while avoiding companies with elevated levels of RBC risks.
In addition to best in class approaches, many institutional investors have in recent years favored a tilting approach as a means of reducing sustainability risks. Such an approach over-weights or under-weights the components of an index based on their sustainability performance. UBS-AM has pursued customized solutions using this approach for a number of institutional clients including tilting around specific issues such as labor and human capital management, good governance, and environmental and climate risks. Such solutions may also apply screening or exclusions around certain business activities or controversies. These tilting strategies offer the advantage of significantly improving the sustainability profile of the portfolio while still seeking to tightly manage the tracking error, thus representing an attractive alternative to traditional index strategies for many institutional investors.

Industry collaboration is essential

Given that sustainable passive offerings often require tracking a sustainability index offered by third-party index providers, UBS-AM pursues active engagement with leading index providers to communicate expectations as well as to collaborate with index providers on developing new indices. UBS-AM has extensive experience in working with index providers to drive innovation and new index solutions. Examples include: collaborations with MSCI to develop the MSCI SRI Index series, with S&P Dow Jones in developing the first S&P 500 ESG ETF, and with the Index provider Solactive to launch the UBS Global Gender Equality ETF as well as the Solactive UBS Global Multilateral Development Bank Index Family. These collaborations are essential to drive innovative index product offerings for clients and thereby create opportunities for clients to choose more sustainable index offerings.

In order to promote sustainability standards in indices more broadly, UBS-AM also works with industry initiatives to strengthen index standards. Specifically, in 2019, UBS-AM joined an initiative of Swiss Sustainable Finance and the UN PRI to exclude controversial weapons producers from market cap indices globally.[6] UBS-AM also regularly participates in index consultations on the methodologies and research underling new sustainability indices from leading third party providers. Given the systematic role that index providers play in driving the market for sustainable investing, collaboration with index providers has an impact beyond UBS-AM's own product range. Partnering with index providers expands the overall market in sustainable investing and ensures that clients are offered a robust range of index options to pursue both their sustainability and financial objectives.

[5] The MSCI SRI Leaders Indices utilize MSCI ESG Research for the sustainability performance scores and the screening for violations of the UN Global Compact.
[6] Information on this initiative can be found at: https://www.sustainablefinance.ch/en/engagement-initiatives-_content---1--3117.html

Monitoring sustainability risks across passive holdings

While sustainable passive strategies can provide opportunities for clients to reduce their exposure to RBC risks prior to investment, the OECD also recommends that investors pursue a risk-based assessment of passive holdings to mitigate risks once investments have been made. Not only can RBC issues emerge over time within sustainable index strategies, but large asset managers will also have clients with exposure to traditional market cap indices where a monitoring of RBC risks is required. Indeed, as a large passive manager, UBS-AM maintains exposure to over 11,000 companies across both sustainable and traditional market cap strategies, and thus a risk-based monitoring of RBC risks across holdings is essential. This risk-based monitoring serves not only to identify risks across portfolios but is also one of the factors used to prioritize stewardship cases where engagement is needed and likely to have an impact.

In order to monitor RBC risks across holdings and prioritize companies for engagement, UBS-AM utilizes a proprietary ESG risk dashboard, which combines sustainability scores and data on over 11,000 companies on material ESG risks. The risk dashboard flags companies with elevated levels of ESG risks by highlighting those companies with consistently poor sustainability scores across several research providers. In addition, the ESG risk dashboard flags companies that may have elevated absolute levels of ESG risk based on sector exposure, poor governance performance, or significant human rights or environmental issues reflected in the company's failure to comply with the UN's Global Compact principles.

UBS-AM monitors RBC risks across its holdings in several ways. First, UBS-AM leverages the in-depth integration work of fundamental analyst teams to identify risks and potential cases for engagement for companies that are held across both active and passive strategies. UBS-AM's fundamental equity analysts analyze the materiality of risks flagged in the ESG risk dashboard and assess the engagement potential of companies with elevated levels of ESG risks. This analysis serves as a basis for not only identifying RBC risks but also prioritizing companies for engagement to redress the risks identified.

Second, UBS-AM's Sustainable Investment Research & Stewardship team references the ESG risk dashboard to monitor a core stewardship universe of companies across UBS-AM's largest holdings in both passive and active strategies. This core stewardship universe provides a basis for prioritizing engagement meetings in association with annual shareholder meetings. The analysis of the core stewardship universe can identify elevated levels of RBC risks in companies where UBS-AM has a large ownership stake, and where engagement with the company may be required to address RBC issues with management both prior to and following proxy voting decisions.

Third, in identifying companies in violation of the UN Global Compact, the ESG risk dashboard provides a basis for monitoring all companies across both active and passive holdings where RBC violations may have occurred. Companies flagged for UN Global Compact violations are assessed by the SI Research & Stewardship team for materiality and engagement potential, and this analysis then leads to engagements with companies to remediate violations of the UN Global Compact principles.

By utilizing the ESG risk dashboard across active integration cases and voting analysis as well as monitoring RBC violations across all passive exposures, UBS-AM pursues a risk-based assessment across its holdings to identify those companies with elevated levels of RBC risks and where UBS-AM has the greatest potential to mitigate those risks through its stewardship activities.

UBS Asset Management's stewardship approach

In addition to recommending a risk-based assessment of sustainability risks, the OECD also recommends engagement with passive holdings where RBC issues emerge. UBS-AM's risk-based approach to identifying companies with elevated RBC risks provides a foundation for prioritizing stewardship activities, which includes both proxy voting and engagement. As a large passive investor with exposure across a wide range of both sustainable and traditional strategies, we believe that these stewardship activities represent the most important impact on companies in mitigating RBC risks.

UBS-AM's stewardship principles have developed over 20 years and focus on core principles of good corporate governance, mitigating climate change risks, promoting fair labor standards and sound human capital practices. Voting shares in line with these principles at annual meetings is a key mechanism to influence companies, express discontent, and support resolutions in line with long-term shareholder and stakeholder interests. In 2020, across passive and ETF products, UBS-AM voted at over 11,000 company annual meetings in line with these stewardship principles and consistent with its sustainability goals. All votes are executed in accordance with a customized voting policy, and UBS-AM views voting as a key mechanism to drive change at investee companies. In 2020, UBS-AM supported 72% of environmental and social resolutions, including 88% of all climate resolutions at annual shareholder meetings. All voting decisions and rationales are published on a quarterly basis publicly so that companies can understand expectations and areas for potential improvement.

UBS-AM's voting supports and reflects its engagement activities which prioritize companies in order to mitigate sustainability risks. Company meetings with management are classified as engagements only in those cases where UBS-AM actively expresses expectations and goals for improvement. In 2020, UBS-AM conducted 430 engagements across a wide range of sustainability issues. By leveraging the ESG integration work of fundamental analysts, the majority of these engagement meetings were with senior management, including board Chairs, CEOs or CFOs, in order to have the greatest impact and influence on company strategy. All engagements are conducted not on behalf of a particular fund or strategy but rather on behalf of all holdings at UBS-AM. This allows engagements to leverage UBS-AM's combined holdings across active and passive in order to maximize their impact and to provide a consistent message to companies of expectations for improvement.

Across both passive and active holdings, engagements are systematically tracked and progress is measured against goals over time. This systematic tracking enables reporting on engagements in the public domain through an annual stewardship report. The stewardship report provides transparency on overall expectations of companies as well as concrete examples of engagements that have resulted in outcomes as a result of our engagement activities.[7]

While engagements linked to the UN Global Compact failures represent some of the most challenging engagement cases, they also represent some of the most important in terms of realizing significant progress. As an example, starting in 2017, UBS-AM pursued an intensive and on-going engagement with a pharmaceutical company that was flagged as being in breach of the UN Global Compact as a result of issues relating to bribery and corruption. Over a period of three years, UBS-AM held multiple meetings with senior management, including the CEO and Board chair, to express expectations of improvements needed in the company's compliance and business culture. The result has been fundamental changes to the company's hiring practices and incentive structure, significant improvements to the oversight structure of management and the board of directors, and a strengthening of the company's compliance policies and practices. These changes have also been reflected toward the end of 2020 by significant improvements in the company's ESG performance score from third party ESG ratings providers.

[7] UBS-AM's stewardship report can be found at:
https://www.ubs.com/global/en/asset-management/insights/sustainable-and-impact-investing/2020/aligning-activities.html

Conclusion

As passive strategies have grown significantly in importance over the past decade, challenges have emerged for investors and asset managers from a sustainability perspective in terms of potential exposure to companies with elevated levels of RBC risks. As a manager committed to sustainable investment, UBS-AM strives to address these challenges through on-going collaboration with index providers to develop sustainable indices that mitigate RBC risks and represent compelling alternatives to traditional market-cap based indices.

In addition, UBS-AM pursues a risk-based approach to assessing RBC risks across strategies through the integration of sustainability into the research process and by monitoring UN Global Compact controversies across its holdings. Finally and most fundamentally, through voting and engagement with management in line with stewardship principles to mitigate RBC risks, UBS-AM can redress issues of significant harm at investee companies and thereby have the greatest potential positive effect on the stakeholders and the communities in which investee companies operate.

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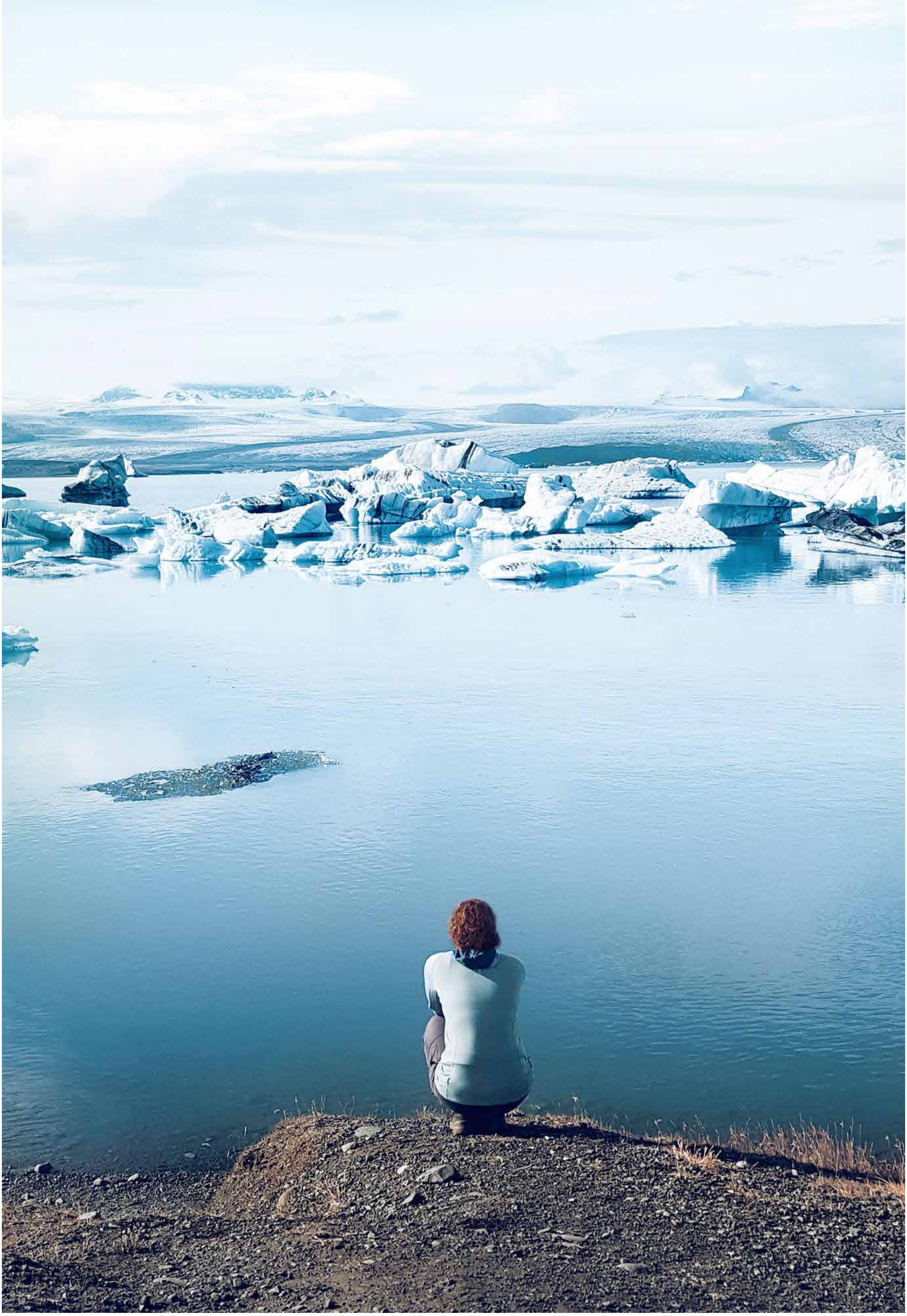

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