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ESG integration in active equities

UBS Asset Management | Sustainable and Impact Investing

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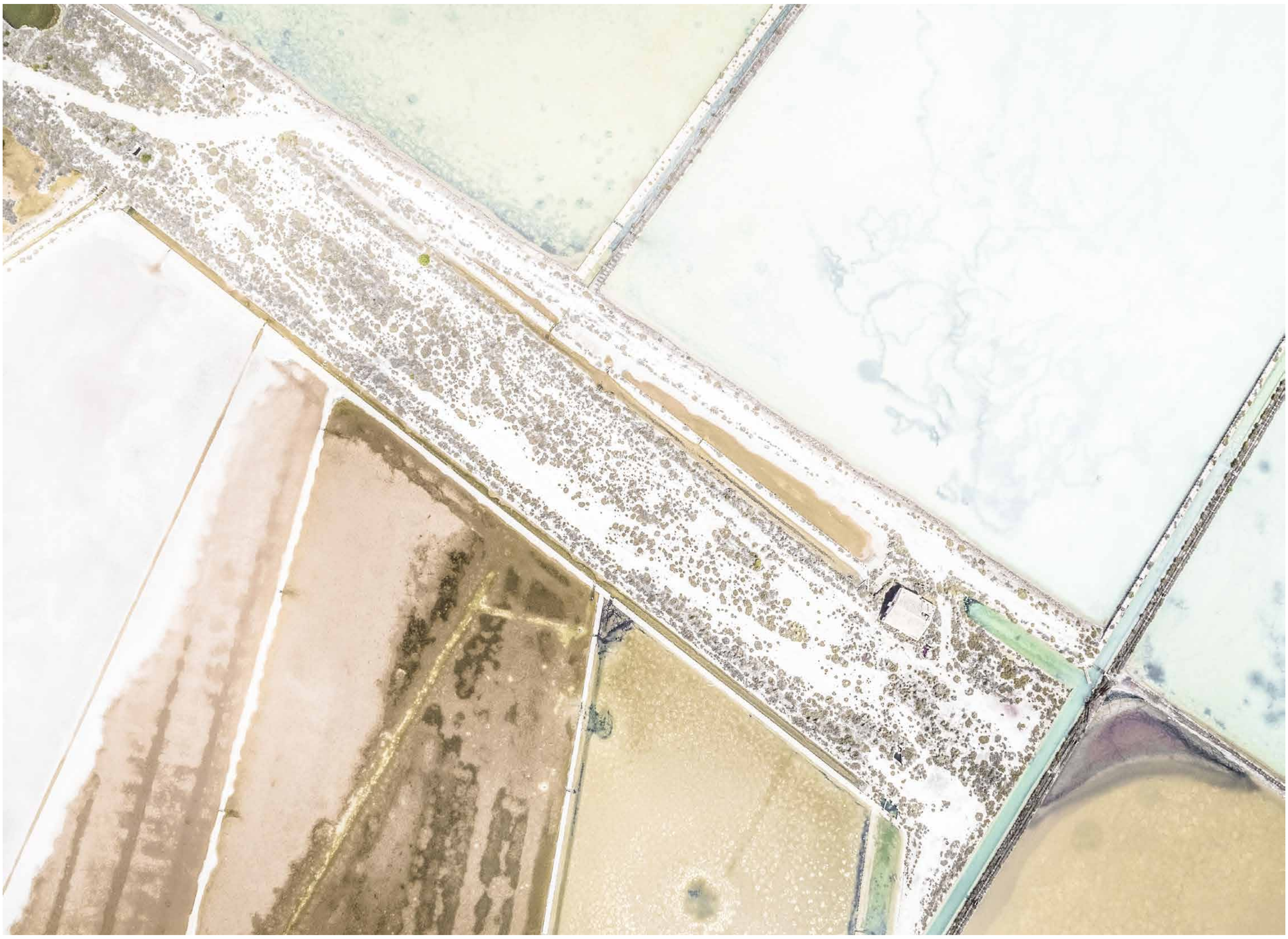
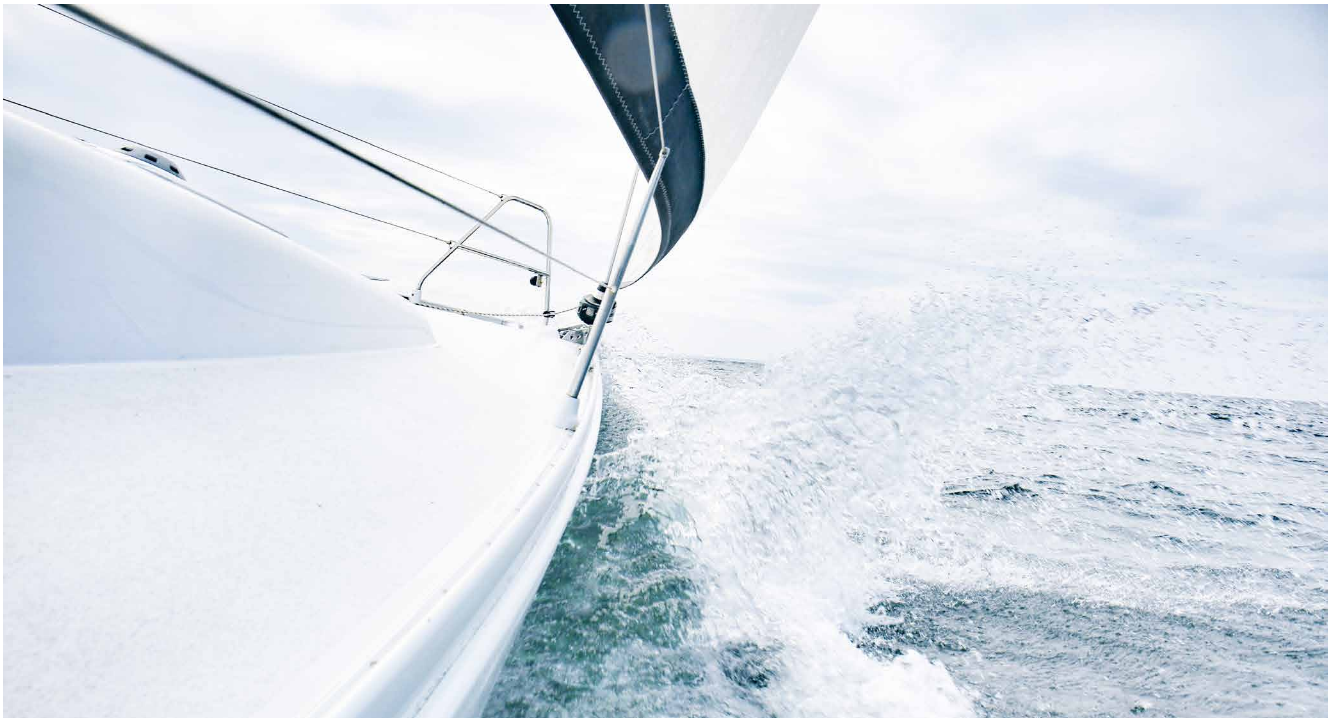


Introduction

The integration of ESG (Environmental, Social, Governance) risk into mainstream equity investing: UBS Asset Management's approach

The rapid growth in sustainable investment represents perhaps the most remarkable trend within asset management over recent years, as evidenced by the number of signatories to the United Nations Principles for Responsible Investment which now exceeds 2,500 and represents over USD 80 trillion in assets[1]. While this growth has seen immense innovation and product development to meet the needs of investors interested in sustainable investing, it has also led to a proliferation of different approaches in the market. The emerging EU taxonomy has been an important first step in establishing a common definition for products that are marketed as "green" investments, but a common standard does not currently exist to define the integration of environmental, social and governance factors into the investment process for mainstream investors.



UBS forges ahead in sustainability

In this paper, we explain our approach to the integration of ESG risk into active equities:

- We introduce UBS' taxonomy of sustainable investing in order to clarify the nature of ESG integration, done through a comprehensive assessment of sustainability risks across our investment strategies.
- We outline our approach to identifying ESG risks in our research process.
- Finally we explain how three strategies from both developed and emerging markets integrate sustainability to mitigate material risks in order to enhance long-term returns.

[1] www.unpri.org/about-the-pri, January 2020

ESG integration and the assessment of material ESG risks

In order to clearly distinguish between the various approaches to sustainable investing, UBS has developed a taxonomy which serves as the basis for our annual reporting of sustainable investment assets.

ESG integration strategies

Sustainability is included in the research process in order to enhance risk and return.

Sustainability focused strategies

The portfolio construction process leads to a better sustainability profile than the benchmark.

Impact investment strategies

The explicit goal is to have a positive environmental and social impact while generating competitive financial returns.

In its annual report, UBS reports on its asset growth across all three approaches. Each category has demonstrated significant growth over the past three years, representing the rapid rise in client interest in sustainable investing.

Sustainable investments		For the year ended			% change from
USD billion, except where indicated	GRI	31 Dec 19	31 Dec 18	31 Dec 17	31 Dec 18
Core SI products and mandates	FS11	488.5	312.9	181.7	56.1
Integrated – sustainability focus	FS11	46.4	20.0	12.8	132.0
Integrated – ESG integration	FS11	372.3	224.5	63.2	65.8
Impact investing	FS11	9.1	4.7	2.8	93.6

Source: UBS GRI Report 2019

The chief focus of this paper is to provide a deeper understanding of the integration of ESG factors in our active equity portfolios.

First

ESG integration entails an expansion of the scope of information used in the research process to include environmental, social and governance factors, rather than a limitation of the investment universe.

Second

ESG integration is fundamentally an enhancement of the underlying research process to take better account of material sustainability risks that can negatively impact financial performance.

Third

Most fundamentally, integration is driven by a focus on taking better account of material risks and thereby enhancing investment returns, rather than being driven by ethical principles or norms.

Most simply, ESG integration involves a more holistic accounting of sustainability factors in the research process. We believe this leads to better informed investment decisions which could enhance performance and reduce risk.

ESG Material Issues Framework

Material issues

3 to 5 material issues per sector from a risk perspective informed by SASB (Sustainability Accounting Standards Board) framework[2]

Value drivers

Influence on value drivers, i.e. regulatory risk, cost impact, operational risk, litigation risk

Timing of the risk

Current and prevailing or progressive and emerging (3 years +)

Impact

Significance of the impact on the risk profile (moderate to significant)

Integration

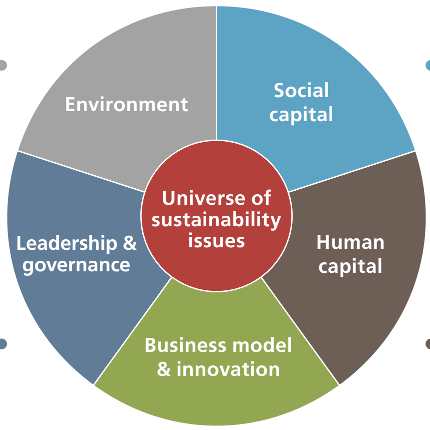
Framework applies for sustainability integration in both equities and fixed income

The integration of sustainability is oriented around the ESG Material Issues framework that the UBS Asset Management (UBS-AM) Sustainable and Impact research team has developed to facilitate the integration process. Because sustainability encompasses many topics, financial analysts and portfolio managers need to focus their attention on a limited set of factors that have the potential to impact the company's financial performance.

The ESG Material Issues framework identifies the 3 to 5 most financially relevant factors per sector that can impact the investment thesis across 32 different industry sectors. This orientation toward financial materiality ensures that analysts focus on sustainability factors that can impact the bottom line and therefore investment returns.

Environment
- GHG emissions
- Air quality
- Energy management
- Water & wastewater management
- Waste & hazardous materials management
- Ecological impacts

Social capital
- Human rights & community relations
- Customer privacy
- Data security
- Access & affordability
- Product quality & safety
- Customer welfare
- Selling practices & product labelling



Leadership & governance
- Business ethics
- Competitive behavior
- Management of the legal & regulatory environment
- Critical incident risk management
- Systemic risk management

Human capital
- Labor practices
- Employee health & safety
- Employee engagement, diversity & inclusion

Business model & innovation
- Product design & lifecycle management
- Business model resilience
- Supply chain management
- Materials sourcing & efficiency
- Physical impacts of climate change

[2] www.sasb.org/standards-overview/materiality-map/

Addressing sustainability risks

As well as focusing on material issues, ESG integration requires a mitigation of sustainability risks, which is a minimum requirement for virtually all investors regardless of their explicit commitment to sustainable investment. This risk mitigation entails a prudent consideration of material risk factors that could have a negative impact on the company's performance.

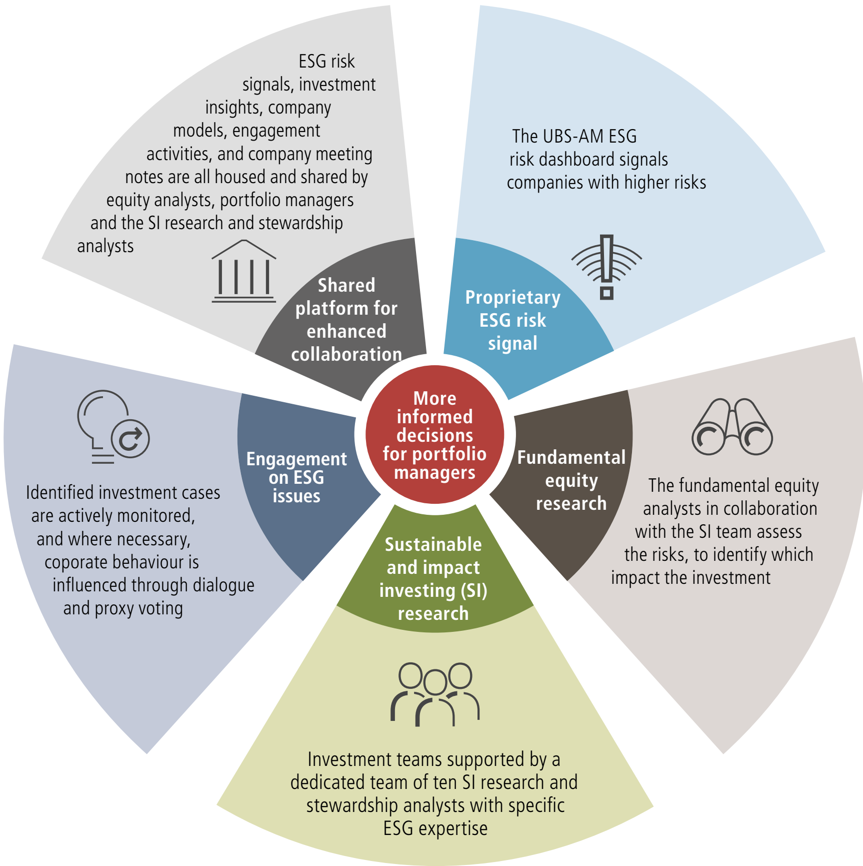
The infamous examples BP, Volkswagen, and Equifax, all had weak sustainability profiles prior to the events that led to significant declines in the share price.

The importance of ESG risk mitigation for investors is supported by a number of recent studies demonstrating that the primary out-performance from sustainability arises from its impact on company specific risks. In a 2018 article, MSCI demonstrated that the primary driver of out-performance of more sustainable portfolios arose from avoiding negative event risk in companies with weaker sustainability performance.[3] The infamous examples of BP, Volkswagen and Equifax showed that all had weak sustainability profiles prior to the events that led to significant declines in the share price. Indeed, UBS-AM's own quantitative research concluded that the out-performance from sustainability arises primarily on a risk-adjusted basis.[4] Avoiding significant material sustainability risks in the portfolio can, in turn, help strategies avoid companies with elevated potential for event risk, which in turn can lead to significant headwinds in portfolio performance.

[3] MSCI, "How ESG affects equity valuation and risk performance," Sustainable Investment Handbook, 2018, pp. 18-49.
[4] UBS Asset Management, "Adding Value through Active Engagement," 2018, pp. 4-5.

ESG risk assessment

To facilitate the integration of sustainability factors through the assessment of material ESG risks, UBS Asset Management has developed a proprietary "ESG Risk Dashboard".



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Identify

This risk dashboard combines scores and data points from our own proprietary ESG database together with a number of the most reputable external research providers to flag companies with elevated sustainability risks that require more in-depth work to assess the material impact of these risks. While the methodologies of ESG ratings providers have significant differences, consistently low scores across varying providers serve as an efficient means of identifying companies with severe ESG risks and for whom additional analysis is required. Additionally, while conducting ESG risk assessments, it is important to consider not only performance scores but also underlying absolute signals of ESG risk, such as poor corporate governance and elevated ESG controversy levels. This can help to identify companies with significant ESG risks across portfolios.

Review

While the UBS-AM ESG Risk Dashboard is designed to flag companies with elevated sustainability risks, the actual assessment of these risks is conducted by the fundamental equity analyst or portfolio manager working with members of the Sustainable Investment research team. All company research produced by investment teams include a series of questions or a section that specifically addresses ESG issues. Specifically, fundamental equity analysts must explain whether and to what extent they agree with the risk signal from the ESG risk dashboard, and if there is potential to engage with company management to mitigate the risk. The assessment also questions if and to what extent the ESG risks may have impacted conviction levels of the fundamental recommendation. For companies where the equity analyst or portfolio manager disagrees with the risk signal, a second level of analysis is conducted by the sustainable investment research analysts to provide an additional assessment of the ESG risk as well as the potential to actively engage management to mitigate the risk.

Decide

The portfolio manager may still choose to invest in a stock flagged for severe ESG risks, but only if he or she believes that the upside potential outweighs the risks identified. In addition, if the potential for improvement through engagement has been identified, the portfolio manager may decide that engagement with management on the risks identified represents the best strategy and may be linked to potential upside in the share price if these risks are mitigated.

In other cases, however, the material risks identified that have a negative impact on the investment thesis may lead the portfolio manager to reduce or sell the stock in order to mitigate the portfolio's exposure to the ESG risks and therefore limit the possibility of poor performance in the future. This combination of the initial screening of the risk dashboard together with the analysis of both the fundamental and sustainable research analysts ensures that portfolio managers are fully aware of any material sustainability risks that could have a negative impact on portfolio performance.

While UBS-AM has developed a common risk dashboard that is used across all active teams, the integration of ESG is the responsibility of the portfolio managers and analysts. We have a range of distinct investment processes and the Sustainable Research analysts work across the teams, supporting them and ensuring best practice.

In the following section, we give examples of the ways in which ESG is being integrated across three of our teams, providing tangible case studies.

Concentrated alpha

One of UBS-AM's largest strategies employing this rigorous process of risk assessment, analysis and engagement is the **Global Equity Concentrated Alpha Strategy**. Integral to this strategy, managed by the Global Equity Concentrated Alpha team, is a three circle assessment which combines fundamental qualitative and quantitative signals. Among its aims are the limitation of downside through risk assessment and the optimization of upside opportunities through engagement.

Recent evidence has shown a significant alpha potential in companies that demonstrate improvements in their sustainability performance.

The Concentrated Alpha team, which manages a range of global and european strategies, provides an assessment of the ESG profiles of all companies they invest in. This is conducted formally every month as well as on an ad-hoc basis. For any company that may be flagged for elevated ESG risks, the team will obtain a more in-depth analysis from the Sustainable Investment research team, which includes a discussion of the appropriate actions for the team to take. The dialogue considers whether the sustainability risks that have emerged justify finding alternatives in the portfolio or whether there might be potential in the company addressing the sustainability risks identified. This requires an assessment of whether the risks identified are fully reflected in the company's share price, whether there is potential to resolve the sustainability risks identified, and what the engagement goals and strategy may be. Recent evidence has shown a significant alpha potential in companies that demonstrate improvements in their sustainability performance[5].

[5] Nagy Z, Guise G, (2018) 'How Markets Price ESG: Have changes in ESG scores affected stock prices?' MSCI Research Insight

Case studies

Concentrated Alpha

Case study 1	Media and communications company
ESG trigger	Low ESG rating
ESG assessment	The Sustainable Investment research team verified the severe sustainability risks that contributed to the low ESG rating, stemming from the company's culture and corporate governance oversight mechanism that raised red flags based on the number of controversies involving its customers and employees. The company had consistently been involved in high profile legal action and appeared to be reactive in simply settling court cases, rather than proactively building a mitigation mechanism to address the underlying issues.
Investment decision	To limit the downside, the investment team decided to sell the stock, given the materiality of the risks flagged and the lack of measures taken by the company to address these risks despite increasing concerns.

Case study 2	Software company operating in health care sector
ESG trigger	Low ESG rating
ESG assessment	The Sustainable Investment (SI) research team noted that the low ESG rating was mainly due to a lack of disclosure on material ESG information, also acknowledging that there were areas for improvement in corporate governance (remuneration, board composition). The SI and equities teams engaged in a discussion with management, who revealed that improvements had been made to its governance arrangements over the past year, as well as enhancements in disclosure practices, despite having only been listed for a few years.
Investment decision	The investment team recognized that implementing best practices can take time and viewed the company's welcoming attitude toward investor feedback positively. They decided to maintain their position in the stock based on the belief that there would be further upside from engaging with the company to realize improvements that could contribute to the investment thesis. They agreed to maintain contact with management and to provide input on the development of the company's remuneration plan, among other issues.

Case studies are for illustrative purposes only

European Value: Engagement to drive value

Another team that has promoted active engagement with senior management in order to drive value is the **European Value team**, which manages European and UK portfolios. They emphasize the importance of long holding periods, the in-depth assessment of the management and the importance of developing strong relations with board members in order to understand and influence the successful execution of the company's strategy. The team pursues a deep value approach, often buying companies with execution challenges, and requires intense due diligence of the board and management prior to investment. This due diligence process also includes an ESG risk assessment to ensure that any material issues flagged in the risk assessment are included in dialogue with management and in the engagement goals. Identifying companies that have significant potential to make improvements on material ESG risks can serve as a key driver to the investment case ands help pinpoint deep value cases that are overlooked by the current valuations.

Case study 3	Mining company
ESG trigger	Elevated risk at the stock level
ESG assessment	The stock was flagged for elevated absolute risk in the ESG risk assessment process. The Sustainable Investment (SI) research team confirmed that the ESG risk stemmed from increased incidents in health and safety and bribery and corruption. To assess management's commitment to addressing these issues, the SI team, equity analysts and portfolio managers broadened their engagement beyond the CEO and CFO to include Board members as well as the heads of asset divisions, general counsel and head of ESG. Discussions with the company focused on structural problems, strengthening systems, and the change required in company culture.
Investment decision	The investment team recognized the materiality of the risks and actively participated in multiple engagement meetings with the company over two years. They decided to maintain their position in the company on the basis that the ESG risks could be mitigated and that investments in compliance and conduct as well as accelerated management succession would positively impact the investment thesis over a multi-year time frame. The company proactively continued the dialogue with UBS-AM, enabling the investment team to provide inputs on performance objectives for ethics, safety, board committees and succession planning.

Case studies are for illustrative purposes only

Asia and Emerging Markets: Quality Assessment combined with ESG Risk Assessment

While the ESG risk dashboard provides a starting point for identifying companies in developed markets, there are a number of challenges in emerging markets that require additional attention. First, sustainability disclosure levels lag those in developed markets, which can lead to negative biases in the scores of emerging markets companies. Second, disclosure levels in English are still evolving, and local language skills are important to attain an adequate assessment of the sustainability performance of companies. Finally, regional context is important, as sustainability challenges and risks are often influenced by local factors in terms of the regulatory environment and the cultural context in which the company is based. While traditional ESG data providers face challenges in assessing emerging markets companies, the material significance of sustainability risks is even greater given the evolving nature of governance standards in emerging economies.

To overcome these challenges, the UBS-AM Asia and Emerging Markets research team has developed a proprietary quality assessment in order to provide an additional, bottom up fundamental analysis of the quality of company management. The qualitative assessment includes a section on ESG performance, requiring the analyst to combine the results of the ESG risk dashboard with his or her knowledge of the company's management and operations. This ESG section represents almost half of the analysts' overall quality assessment, and companies with a quality score that is in the lowest quintile are typically not eligible for investment. The quality assessment plays a key role in the Asia and Emerging Markets team's investment process and allows for an ESG performance assessment that leverages the local knowledge of the analyst team and therefore overcomes the limitations of third party data providers in assessing emerging markets companies.

Conclusion

The ESG risk assessment thus supports our fiduciary duty to our clients by better accounting for and addressing ESG risks that can have a material impact on long-term performance.

The ESG Risk Dashboard and risk assessment serve as an important foundation of UBS-AM's overall commitment to sustainability and stewardship. Our approach serves to identify material ESG risks through the investment process and incorporate ESG research into our overall company assessments, thereby helping clients to deliver on their sustainability commitments. Perhaps more importantly, our methods help to establish key engagement goals to mitigate risks for the companies themselves.

UBS-AM believes that this engagement not only has positive impacts on the environment and society, but ultimately serves to enhance long-term returns for our clients. The ESG risk assessment thus supports our fiduciary duty to our clients by better accounting for and addressing of ESG risks that can have a material impact on long-term performance.

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