Sustainable investing after COVID-19

Sustainable investing

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• We expect increased investor focus on ESG considerations after COVID-19, with particular demand for greater corporate transparency and stakeholder accountability.

• Elevated importance of “social” for companies and investors, in particular healthcare, access to medicines, education, sustainable tourism and social bonds.

• Awareness of economic benefits and risk should keep investors focused on environment-related opportunities and the low-carbon energy transition, e.g., renewable energy, sustainable transport, biodiversity and green bonds.

• Structural embedding of SI across asset classes, including those where there has been less progress historically on the inclusion of ESG considerations.

• SI performance benefits should remain evident, as seen during recent market volatility, particularly the defensive characteristics of most common SI approaches, and our expectation for SI instruments and diversified portfolios to generate returns that are comparable to conventional equivalents.

Through the disruption that the COVID-19 pandemic has brought to the global economy and markets in 2020, sustainable investing (SI) strategies and instruments have delivered comparable or better performance than conventional equivalents. This is a short time-frame and an unprecedented situation, so relative performance should not be directly extrapolated over the longer term, but investors with SI exposure within a diversified portfolio should be encouraged by recent short-term returns.

The crisis underscores the relevance of ESG considerations to company performance and investment returns, and we expect that this will continue to influence corporate and investor actions going forward. In this report, we discuss five trends arising or accelerating as a consequence of the COVID-19 pandemic and global mitigation measures, which we think will play out over the next 12 months, affecting the longer-term landscape of sustainable investing.

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1. Increased investor focus on ESG considerations
2. Elevated importance of “social” for companies and investors
3. Awareness of economic benefits and risk should keep investors focused on environment-related opportunities and low-carbon energy transition
4. Structural embedding of SI across asset classes
5. Performance benefits should remain evident, as seen during recent market volatility.

We believe these trends will play out against a backdrop of expected low global economic growth as a consequence of the COVID-19 pandemic. We also observe continued political support for recovery planning that emphasizes a more resilient future, as well as strengthening SI regulatory frameworks in some regions (especially Europe), which were undergoing development before this global crisis. Consequently, we expect to see the growth in SI assets under management (AUM) of recent years (see Fig. 1) to continue even in a very different economic environment.

Figure 1 - Global SI assets under management
USD, billions (in January of each year)

We believe that there is a high likelihood that these trends will play out in the longer term, with the main variable being the timing. Our current expectations are based on a central scenario of a recovery from the crisis, with intermittent lockdowns throughout 2020 leading to low economic growth and a more general rebound in 2021 (see CIO Daily on 16 April). Should the pandemic continue for longer, on a global basis, some trends might emerge that could undermine some SI approaches:

- Increased short-term negative environmental effects, such as increased use of single-use plastic, or temporary relaxation of ESG-related regulation in the name of the pandemic (e.g., the US EPA) but with lasting consequences, exceeding the positive impacts of reduced economic activity (e.g., lower air emissions).
- Corporations that were previously ESG leaders de-prioritizing long-term financially and environmentally beneficial ESG management in favor of short-term wins or urgent business needs.
- Pandemic “politics,” de-globalization, disruption of supply chains, and loss of transparency—these factors are having a clear impact on some companies’ ability to manage essential business processes (e.g., efficient sourcing) and manage sustainability impacts. A breakdown in global partnerships working on solutions to sustainability challenges could be especially damaging for sustainable development, as well as hinder the flow of investment capital into sustainable industries.

Trend 1: Increased investor focus on ESG considerations

COVID-19 has elevated the importance of how companies operate and accelerated the already increasing relevance of ESG considerations to investors, in our view. Corporate management of issues such as human rights, employee wellbeing, and community relations are under scrutiny, as issues that were considered luxuries in the past (e.g., flexible working models) have become critical business continuity mechanisms in the pandemic lockdown and help to maintain public health, social justice, and economic stability.

For example, companies in the apparel industry, which employs some of the lowest-paid workers in developing countries, women in particular, have been publicly criticized for exploiting their financial power by failing to honor orders placed or even already made, leaving suppliers and workers unpaid and jobless. The Bangladesh Garment Manufacturers and Exporters Association is tracking reported export cancellations, worth USD 3.18bn of goods and affecting 2.28 million workers. Some well-known Western retailers are honoring commitments in order to support the industry. Others, more often budget fast-fashion companies, are not, in a move that may well have a negative impact on their reputation and future relationships with customers, vendors and regulators.
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Investors are using their influence to drive behavioral changes, in a sign that shareholder engagement should remain a key component of sustainable investment going forward. UK companies receiving government support, as well as those that suspended dividends, have come under pressure from the UK Investment Authority (a trade body representing investment managers) to cut executive compensation and consider clawing back bonuses amid concerns that companies could continue to reward executives while taking handouts from taxpayers and penalizing investors.

Governments are also holding companies to account. EU companies rescued by public aid will be barred from paying executive bonuses and aggressive commercial expansion until the aid has been repaid, while in Denmark, government bailout programs exclude companies located in tax havens.

Sustainability is at the heart of the recovery plan for many governments. In previous crises, social issues received less attention than economic interests, but today the trade-off between economic interest and public health is the center of the debate over easing lockdown measures, and public health has so far, in most of the world, had the upper hand.

The European Parliament has not only reiterated its commitment to the European Green Deal, a set of policy initiatives launched in December 2019 targeting a climate-neutral Europe by 2050, but is now trying to build post-COVID-19 economic stimulus packages around the goals of the Green Deal. With plans to invest in large-scale renewables, clean transport, sustainable food, and shortening and diversifying global supply chains, this will likely support ongoing investment in sustainable industries, even with short-term setbacks related to the lockdown and the need for urgenfunding to be directed to citizens and essential industries such as healthcare.

The UN Secretary General, at the Petersberg Climate Dialogue in April 2020, encouraged governments worldwide to similarly focus economic rescue packages on businesses that “create green jobs and sustainable and inclusive growth,” and avoid bailing out carbon-intensive industries. This could be particularly beneficial to the expansion of the green bond market, which over recent years has become an outlet for governments to fund various environmental projects in their countries. These bonds provide investors and issuers alike with a tool to promote progress with regard to environmental problems. Investors benefit from a level of transparency, which is not applicable for normal government bond issues.

Looking ahead, governments are also likely to come under pressure to apply a similar level of urgent action to their earlier, long-standing commitments to mitigating climate change, as they have done to COVID-19. Previous arguments that economic activity could not be curtailed or drastic action would not be tolerated have been demonstrably disproven in the response to COVID-19. The question is whether there is the political will to do so.

Growing regulation of corporate ESG disclosures and the SI industry

The EU has been leading the way in terms of regulation of the SI industry; for example, all SI products marketed in the EU from 2021 will need to disclose the degree of alignment with the EU Sustainable Taxonomy. Other regions have increased the demands on companies to be more transparent; for instance, Hong Kong’s Securities and Futures Commission has made it compulsory for public companies to report on ESG factors, and mainland China will introduce a similar requirement this year.

This evolving, more formal industry structure should support the volume of SI assets under management globally in continuing their upward trend, even during a recessionary period (having more than doubled to over USD 30tr from January 2012 to January 2018).

The financial industry plays a fundamental role in driving both economic recovery and SI

In contrast to the 2008 global financial crisis, when banks bore the public blame for causing the crisis, the financial industry is currently playing an important role in buffering the economy, providing liquidity to small businesses, and demonstrating socially conscious employment practices. One third of the financial sector companies in the S&P 500 and Stoxx 600 have created customer relief programs of some type. The COVID-19 crisis is a natural disaster and so far it is mainly governments that have borne the most criticism for their handling and mitigation efforts, presenting the financial industry with an opportunity for redemption that we expect many participants to take up.

Since the 2008 crisis, when the UN Principles for Responsible Investment (UN PRI) was in its infancy after launching in 2006, membership has grown to over 3,000 signatories, including over 500 asset managers and representing assets of USD 89tr. Many conventional wealth and asset managers have made public commitments to SI that go far beyond specialist products, and in many cases SI has become a key business driver.
Trend 2: Elevated importance of "social" for companies and investors

While we expect many long-term dynamics in sustainable investing to retain their existing focus, we are seeing a structural change in focus on social issues. With the possible exception of gender lens investing over the last three years, social issues have played second fiddle to environmental issues for many years. As COVID-19 has focused the world's attention on public health, any social changes that emerge, such as investment in healthcare or elderly care, will ultimately be reflected in new investment opportunities. There are many important social themes but we highlight healthcare, access to medicines, education, sustainable tourism, and social bonds as areas that we think will rise in importance to investors in the aftermath of COVID-19, particularly in the context of improving provision to underserved communities to have a positive impact.

Healthcare and access to medicines
Healthcare-related investment themes have long been popular among sustainable investors, with their direct link to SDG3 (Good Health & Wellbeing) and the nature of the activities often making it possible to quantify some positive social benefits. The COVID-19 crisis has focused the attention particularly on healthtech—the concept of making healthcare more efficient through connectivity and data analysis—and access to medicines. We expect this to rise in importance as the world’s governments seek to protect themselves against future health crises. Remote access to medical care is also particularly relevant to sustainable development (in terms of remote communities being able to access specialist help) and now has new relevance on a global scale when at-risk people can access a doctor without leaving their home. Data analysis has clear relevance in the context of trying to track and contain a pandemic. Even before the crisis, current markets linked to this theme were thought to be worth over USD 100bn (see the latest "Healthtech" LTI report).

Access to medicines has particular resonance at the time of a global need for a COVID-19 vaccine, but it is a sustainability issue that divides investors. Some see it as a philanthropic issue for large pharmaceutical companies rather than financially material, while others believe that making critical medicines affordable to developing countries can lead to revenue-enhancing goodwill and potentially improved access to new markets. Balancing "affordable" prices with the cost of R&D and distribution is unquestionably challenging, and in the context of COVID-19 is clear that it will be politicized, with many governments already taking steps to ensure their citizens will be prioritized. We expect this topic to be widely debated in the coming months, but from an investment perspective it is most relevant to investors who care strongly about aligning their portfolio with their personal values, while others may prefer to focus on financially material issues and support access to medicines via charitable initiatives.

Education
Education, particularly access to education online, has risen in importance with the closure of schools in many countries. While education is usually seen as a government’s responsibility, for the first time in most countries the responsibility to educate children has been given to parents, with highly variable support from overstretched and under-resourced teachers. Amid the USD 6tr education market (see the latest “Education services” LTI report), education technology (edtech) is drawing global attention during the COVID-19 outbreak. Now, with universities and schools globally going online and finding they need better solutions, new training, and more digital resources, it has increased awareness of the potential for private educational solutions to support and complement government delivered education. The expansion of the edtech market has huge potential to increase the availability of a quality education to underserved communities, in our view.

Sustainable tourism
Sustainable tourism has typically been addressed in terms of the environmental impact of transport and accommodation, as well as environmental pollution (e.g., water scarcity, beach plastic, degradation of natural habitats). But with global tourism likely to remain strictly curtailed in the medium term, we expect the social implications of sustainable tourism to rise in relevance. According to the OECD, tourism plays a key role in job creation, export revenue, and domestic value added, and directly contributes, on average, 4.2% of GDP, 6.9% of employment, and 21.7% of service exports in OECD countries. Correspondingly, large numbers of people are reliant on tourism for jobs that are more likely to be transient, lower paid, and with less security than other industries. Prior to the COVID-19 crisis, there was already a need for investment in environmentally sustainable tourism. Following the crisis, socially responsible tourism will likely be essential to economic recovery, in order to support the livelihoods of communities and to prevent recurrences of COVID-19 transmission.
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Social bonds
Social bonds are still a relatively small area of sustainable fixed income, but it’s worth noting that in the context of the rise in interest in social investments, this is one area that could see growth. In April 2020, in the midst of the COVID-19 crisis, issuance of bonds with ESG characteristics increased by 272% y/y, including for the first time, sustainability bond issuance (USD 19.4bn) exceeding green bond issuance (USD 16.8bn) in a single calendar month (according to Morgan Stanley).

Impact investing in social themes
For impact investors, the focus will be on investment opportunities that result in benefits to underprivileged groups. It has become clear during this crisis that people in poorer, more disadvantaged populations are the worst affected by COVID-19 both in terms of incidence and mortality.

Impact private market funds are already more focused on social issues than public funds, tending to have a higher allocation to sectors that have been resilient in the crisis, such as healthcare, education, food and agriculture, as well as financial services. According to the latest survey by the Global Impact Investing Network (GIIN), nearly 50% of impact fund assets are allocated to these five sectors. Companies that provide solutions to the current public health crisis, be it with medical research, online education, or optimized financing, are more relevant than ever. Microfinance could also be one avenue to channel investments into small enterprises that benefit communities. In the short term, such enterprises will face the same struggles as larger businesses in an economic lockdown; in the long term, investment in micro-entrepreneurs can be much more impactful. It should be noted, however, that the developing countries in which microfinance is most used appear to have good containment measures at the moment, but if the COVID-19 crisis were to get out of control, the impact on a country with a weaker healthcare system could be much more damaging.

Trend 3: Awareness of economic benefits and risk should keep investors focused on environment-related opportunities

While the COVID-19 crisis has focused the attention on public health, environmental awareness has not diminished. It has been widely reported that 2020 carbon emissions for countries and most corporations will decrease as a consequence of the economic lockdown; so far, we have seen the largest decline in global carbon emissions on record, with energy analysts now forecasting global energy-related CO2 emissions (two thirds of global greenhouse gas emissions) will fall by more than 5%—i.e., more than four times as much as they fell in previous financial crises. There are also direct links between the environment and the health crises, with preliminary WHO studies identifying correlations between high air pollution and more severe cases of COVID-19.

Investor, corporate, and policy momentum on environment-related issues was accelerating into early 2020, alongside increased societal action such as climate school strikes. Two such examples are the EU Green Deal policies, and the final proposal from the European Commission for a Taxonomy of Sustainable Investments (defining “green” for 70 business activities across a range of sectors accounting for 93.5% of Europe’s greenhouse gas emissions). There is no sign of rolling back these commitments, and we expect environmental themes will continue to be attractive longer-term investment opportunities. In particular, we think that renewable energy, sustainable transport, biodiversity, and green bonds will be in focus in the aftermath of COVID-19.

Renewable energy
The prospects for renewable energy industries have come under scrutiny as a result of the recent decline in oil prices alongside the impacts of COVID-19. While the International Energy Agency initially warned that the economic slowdown could stall renewable infrastructure development, oil and gas analysts predicted that the COVID-19 crisis could have precipitated peak oil demand and that large chunks of the sector would go out of business in a prolonged period of low oil prices and reduced long-haul aviation, hence accelerating the low-carbon energy transition. Taking a longer-term view, the question of when renewable energy would be priced competitively with fossil fuels had largely been answered by the end of 2019—both wind and solar are generally competitive with the lowest-cost fossil fuel generation. The unprecedented—but likely temporary—
energy demand drop and low prices for crude oil do not change this, and may even lower installation costs for some renewables where the manufacturing is still powered by fossil fuels. We therefore do not see low crude oil prices having much impact on the growth of renewables globally, particularly in the developed world where the use of crude oil for power generation is more limited. The longer-term benefits of growth in renewable energy-related industries offer significant potential for countries to create jobs and achieve greater energy independence on top of any price and sustainability benefits, in our view.

**Sustainable transport**
The social and economic lockdown has heightened awareness of not only our need to travel, but also the safety and sustainability of our public transport. Airplanes and overcrowded buses and trains seem like ideal environments for a virus to spread. For commuters, a shift to e-bikes would be healthier and more sustainable, while a shift to cars to maintain social distancing would in the short term have a negative environmental impact; it could accelerate the adoption of electrified cars, however. For longer journeys, shifts from air travel to high speed rail could be accelerated as people become more tolerant of longer but less restrictive travel. Data from a UBS Evidence Lab survey of 1,000 people in four European countries and China suggests leisure travelers would tolerate 5–6 hours on a train, and EU business travelers up to four hours versus the previous consensus forecast of 2–3 hours. Even before the crisis, this was an evolving theme with a potential addressable market of around USD 400bn for the personal vehicle segment alone (see the latest “Smart mobility” LTI report). But in a post-COVID-19 world with increased health concerns, the broader topic including public transport will become even more relevant.

**Biodiversity**
Biodiversity is critical to food production, agriculture, medicine, and other important aspects of our lives and economies, but it tends to receive less attention from investors than climate change or water. We think this will change though, particularly as the original source of the novel coronavirus was reportedly from the animal world—mostly likely from bats—and an association between decreased biodiversity and increased transmission of infectious disease from animals to humans has been a topic of discussion in the scientific community for over a decade. The importance of biodiversity is also highlighted in the EU Sustainable Taxonomy, with “the protection and restoration of biodiversity and ecosystems” being one of the six types of economic activities considered sustainable. It is more difficult to identify industries with an explicit positive impact on biodiversity than it is to find industries focused on, for example, carbon emission reduction; hence, the focus will likely to be on industries that rely on biodiversity, such as the food supply chain, and companies that are ESG leaders in terms of reducing the negative impact of their operations. It is also a topic that impact private market investors may be better positioned to focus directly on with a smaller number of specialist enterprises.

**Green bonds**
Green bonds are already a core component of our SI portfolio approach, and we expect they will continue to play a key role in fixed income investments with sustainability themes. The green bond market has accelerated since 2014 to a total market size of around EUR 750bn. Demand remains high and green bonds are likely to play a key role in the European Commission’s action plan to finance sustainable growth, with developments around EU green bond standards not only providing strong drivers in European green bond markets, but also having a global effect on the quality of green bonds, and influencing advancements with regard to other investment products along the lines of transition, social, and SDG-linked bonds.

**Trend 4: Structural embedding of SI across asset classes**
A low-growth and low-bond-yield environment should drive the adoption of SI philosophies and new issuance over a wider range of asset classes and instruments, diversifying beyond the dominance of equities and, more recently and to a lesser extent, bonds. This is an area in which we see the potential for structural changes in SI, together with innovation in SI-aligned investment strategies in alternative asset classes. However, attention will need to be paid to the sustainability benefits of new approaches, to avoid “green washing”.

To date, equities have dominated the SI market, with interest in ESG integration into fixed income ramping up only in the last few years. For example, many of the early equity ESG index funds came to market around the turn of the century, while most passive ESG bond funds have only been launched in the past three years. At the end of November 2019, assets in the European passive ESG bond-fund market amounted to EUR 11bn, representing only 2% of the money invested in European passive bond funds. By contrast, assets in European passive ESG equity funds surpassed EUR 110bn, accounting for 9% of the European passive equity-fund market, according to data from Morningstar.
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The “alternatives” investment space has made even fewer inroads, with the exception of private equity. Private debt strategies remain fairly specialized (e.g., microfinance), and fewer hedge funds have systematically integrated ESG considerations compared with long-only funds. Collectively, SI approaches in hedge funds, cash or depository vehicles, commodities and infrastructure represented less than 7% of global SI AUM in 2018 (see Fig. 2).

Figure 2 - Global SI Asset Allocation
As at January 2018

While there has been considerable interest in the last couple of years from hedge fund managers in adopting SI principles, those that have done so are primarily long-short strategies, in which similar approaches to long-only approaches can be used. In a diversified portfolio therefore, it is very difficult to implement a systematic approach to sustainable hedge fund exposure.

Our view is that hedge funds, structured products, and potentially other derivatives could provide sustainable investors with important risk management capabilities using underlying securities that have a link to their personal values or to sustainable economic activities. They would make most sense when used as diversification to a core SI portfolio, particularly where the investor wants to remain a long-term holder of other sustainable assets but manage interim risk related to market movements, currency, capital protection, tax efficiency, etc. Arguably, hedge funds and derivatives are the next frontier of SI.

However, in our view, most derivative instruments offer only values alignment or exposure to thematic performance, with usually few or no beneficial sustainability outcomes, such as no ability to engage in active ownership and minimal signaling on sustainability issues. As such, they might be considered “SI-aligned” rather than fully sustainable, since the opportunity to drive sustainable change is considerably reduced, but it would depend on the specific characteristics. For example, one could envisage a specialized investment vehicle that allows investors to gain access to sustainable or impactful investments that would otherwise not be available to investors.

Trend 5: SI performance benefits should remain evident, as seen during recent market volatility

SI strategies are not a homogenous group of investment strategies (for example, our SI portfolio identifies eight distinct, although not mutually exclusive, categories of SI approaches and instruments—see Fig. 3), but in aggregate, the performance of ESG indices, funds that self-declare as sustainable, and specific ESG instruments was highly resilient in the first quarter of 2020. Portfolios that contain diversified SI approaches are positioned defensively relative to conventional portfolios, in our view, with upside opportunities to be found in ESG themes and ESG engagement.

Figure 3 - SI approaches in the UBS SI Strategic Asset Allocation
as at 1 May 2020

<table>
<thead>
<tr>
<th>Corporate bond ESG leaders</th>
<th>Bonds issued by companies that manage a range of major ESG issues (and seize opportunities) better than their competitors.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development bonds</td>
<td>Bonds issued by multilateral development banks (MDBs). MDBs are backed by multiple governments with the aim of financing sustainable economic development.</td>
</tr>
<tr>
<td>ESG engagement equities</td>
<td>An approach where fund managers take active equity stakes in companies. They do this to engage company management on improving their ESG.</td>
</tr>
<tr>
<td>ESG leaders equities</td>
<td>Equity shares in companies that manage a range of major ESG issues and seize opportunities better than their competitors.</td>
</tr>
<tr>
<td>ESG thematic equities</td>
<td>Equity shares in companies selling products and services that tackle environmental and social challenges, and/or are good at managing one ESG factor, such as gender equality.</td>
</tr>
<tr>
<td>Green bonds</td>
<td>Bonds that finance environmental projects. Issuers include corporations, municipalities, and development banks.</td>
</tr>
<tr>
<td>Improving ESG equities</td>
<td>Equity shares in companies that are getting better at managing a range of major ESG issues and opportunities.</td>
</tr>
<tr>
<td>World Bank bonds</td>
<td>Bonds issued by the World Bank, which is a multilateral development bank (MDB). Multiple governments back MDBs, aiming to finance sustainable economic development.</td>
</tr>
</tbody>
</table>

Source: UBS CIO
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**SI equities anchored by large-cap, quality tilt of ESG leaders**
In 1Q20, the returns of 70% of self-identified sustainable equity funds ranked in the top halves of their categories and 44% ranked in their category’s best quartile. By contrast, only 11% of sustainable equity funds finished in their category’s worst quartile (see Fig. 4). These statistics are at the global level, but the trend showed within the US, global, and emerging market subsets too, corresponding with previous analyses that have found that during periods of turbulent markets, such as the global financial crisis of 2008, sustainable funds’ downside deviation was significantly smaller than traditional funds (based on Morningstar data). We see the same pattern in the performance of SI equity indices, with both global and regional SI indices outperforming their conventional peers year-to-date (see Fig. 5).

The key drivers of this outperformance are:

- A bias toward high-quality, larger companies: year-to-date, quality and growth investment styles have outperformed value and large-cap has outperformed mid-cap (Figure 6);
- The crash in oil prices in March 2020: SI strategies (especially those with an exclusion component) tend to underweight energy relative to conventional benchmarks, sometimes avoiding fossil fuels altogether.

**Figure 4 - SI funds tended to perform in the top two quartiles of their investment category in 1Q20**

Source: Morningstar

**Figure 5 - MSCI “ESG Leaders” indices outperformed in 1Q20 compared with equivalent all-market indices**

Source: MSCI, UBS

While SI is a philosophy that can be adopted across all asset classes with considerable variation in its interpretation, most equity strategies (especially indices) in the market still focus on ESG leaders, or best-in-class type strategies more than any of the other approaches in our SI portfolio (see Fig. 7). Screening type approaches tend to be biased towards high-quality companies with strong governance, and often towards larger companies that have the resources to manage a wide range of ESG issues and be transparent toward stakeholders, thus scoring highly on ESG assessment criteria.

Thematic ESG investing is growing in prevalence, and is more likely to identify companies with revenue exposure to growth industries, an investment style that has also held up well this year. Conversely, ESG engagement strategies are more likely to have exposure to smaller, mid-cap companies as these are the companies with whom engagement tends to be more effective. There are still few truly engagement-focused funds available, but those investors who do have SI portfolios containing engagement equities will have seen some drag on performance in recent months. However, over the longer term, they should be better positioned across the cycle to capture upside.

Looking ahead, we still expect a diversified portfolio of global SI equities to perform overall in line with conventional equity strategies. While the ESG leaders and improvers approaches (that we define in Fig. 3) will offer slightly more defensive characteristics, we think allocations to ESG themes and ESG engagement equities and high yield bonds will be the cornerstone of growth and returns opportunities.
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Figure 6 - MSCI ACWI quality, growth and large-cap tilted indices outperformed value and mid-cap tilted indices in 1Q20

<table>
<thead>
<tr>
<th>MSCI ACWI: Quality</th>
<th>Growth</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>-9.72%</td>
<td>-9.05%</td>
<td>-25.04%</td>
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<table>
<thead>
<tr>
<th>MSCI ACWI: Large cap</th>
<th>Mid cap</th>
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<tbody>
<tr>
<td>-15.88%</td>
<td>-22.74%</td>
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</table>

Source: MSCI, UBS

Figure 7 - Strategies focusing on screening - identifying best in class or eliminating worst in class - dominate the SI landscape

Source: Global Sustainable Investment Alliance, UBS. Note that engagement strategies in this analysis are mainly engaging as a consequence of investment, not engagement driven strategies as defined in the UBS SI SAA (see Fig. 3).

SI fixed income approaches benefit from defensive high grade, green bond, and MDB exposure

SI fixed income strategies were also highly resilient in 1Q20. Analyzing Morningstar data suggests that on aggregate, the diverse group of self-declared sustainable global fixed income strategies saw NAV fall 1.1% on average to the end of March, compared with conventional bond indices’ drop of around 6%. This is primarily because the credit exposure in SI bond strategies is typically focused on investments in corporate bond ESG leaders and green bonds, exposures that tend to be tilted toward high grade and investment grade credit and less to cyclical sectors, notably energy, in comparison to the broad corporate bond market.

Our SI portfolio approach focuses on bonds of the highest credit quality as the main building block for a diversified portfolio: ESG leaders corporate bonds, green bonds, and development bank bonds. These bonds are intended to provide a modest contribution to portfolio returns during good times and protect the portfolio’s overall return against risk asset losses during market corrections. Another building block of our SI portfolio, ESG engagement high yield debt, focuses on lower-rated issuers. While this would normally offset the stable impact of higher rated bonds, in practice we find that a typical ESG engagement-focused strategy tends to be more tilted to higher credit quality than a conventional high yield benchmark, as a consequence of an investment selection process that actively seeks opportunities to engage for a positive change.

Although general fixed income market performance was shaped by volatility, illiquidity, and forced selling in March 2020, the unprecedented speed and size of support measures put in place by policymakers provided a necessary backstop. (For a detailed overview of overall market developments, please refer to the CIO publication “Credit Market Deep Dive: Attractive opportunity, selectivity is key” dated 14 April 2020.) During the March sell-off, high grade bonds lost all their previously accumulated returns of the year, so that their performance contribution to a diversified portfolio was close to zero. However, multilateral development bank (MDB) bonds (used in sustainable portfolios in place of US Treasuries or global high grade bonds in conventional portfolios) generated significantly positive total returns and helped cushion against the losses from risky assets.

A general positive observation is that investment grade-rated issuers, in particular, were able to tap primary markets with large new issue volumes and often long tenors, even during the most difficult weeks of March, first in USD and then also in EUR markets. These transactions often came at significant new issue premiums; but in previous crises, primary markets often remained closed for several weeks. Central bank purchasing programs played a fundamental role in this respect and helped to mitigate liquidity or refinancing concerns for bondholders.

Normally, we would not expect to see a sudden increase in sustainable bond issuance given that they require additional criteria such as specific project funding and reporting, and therefore are not suitable for ad-hoc general balance sheet management. However, it is notable that several new bonds with specific social aims were issued, mainly by development banks, in order to address COVID-19-related social problems (see our report “COVID-19 pandemic: Investors focus on dual returns,” dated 30 March, for further detail on MDBs).

Currently, global MDB bonds offer attractive risk premiums, in our view, compared to US Treasuries of around 25–30bps for medium tenors. We expect these to narrow back toward
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10bps once the liquidity premium moves back to more normal levels when the economic situation stabilizes and the Federal Reserve phases out its massive bond purchases; this would represent an effective defensive play, according to UBS research (please refer to the CIO publication “Green bonds and global MDBs: Defensive during the crisis,” dated 20 April, for more details). Year-to-date performance remains in line with high grade conventional corporate bonds, but in our view offers more protection in the current downturn.

Green bonds, on an index level, exhibit positive total returns year-to-date, while traditional investment grade corporate bond indices showed slightly negative ones in March and early April but then started to move tighter again. Also, drawdowns from early March peaks have been smaller for green bonds (~7% versus ~12%). Nevertheless, fueled by central bank support, traditional corporate bonds have benefited from a stronger bounce-back. However, we continue to expect green bonds to exhibit lower volatility and smaller drawdowns compared to non-green bonds during periods of market stress. Investors wanting to benefit from the currently elevated risk premiums in bond markets but who are concerned about the high level of economic uncertainty should favor green bonds over IG corporate bonds.

A defensive way to benefit from currently elevated bond risk premiums is also to favor green bonds over high grade bonds, Treasuries, or MDBs.

**Impact private markets: more experienced managers likely to have an advantage**

Similar to conventional private market investors, impact fund managers are focused on portfolio resilience during a downturn, namely ensuring the investee companies have sufficient liquidity to face potentially lower customer demand, and temporarily slowing down on new company investments. While most managers admit that it is too early to draw conclusions on how impact and financial performance will be affected, three key factors need to be taken into account: sector exposure to social themes, the underlying investment strategy, and the experience of the fund manager in facing economic downturns.

In terms of investment strategy, impact funds tend to focus on growth and mature companies (about 61% of assets according to GIIN), with a relatively even mix of private debt and private equity. Earlier-stage ventures may face tougher liquidity issues and force managers to explore new financing avenues. As with conventional investments, valuations will most likely be under pressure, so impact managers will need to focus their effort on chasing operational value creation while still delivering on their impact thesis.

The current environment will test the skills and abilities of impact funds to manage impact and financial performance with equal rigor. Many impact investing strategies are less than a decade old, and most likely this is their first crisis situation. At the same time, funds of earlier vintages are just in the middle of value realizations and face difficult exit markets and unclear valuations. Funds that are currently looking to close in 2Q20 and 3Q20 are expected to experience difficulties due to the challenging logistics of due diligence, marketing and networking activities. At the same time, 2020 vintage funds could also benefit from lower-than-usual valuations for underlying investments. Private companies with stronger sustainability strategies could benefit from the short-term stimulus programs, especially in those countries where governments consider environmental and social impact in their funding decisions.

In summary, we view fund managers who have set robust impact management frameworks since inception and have experienced engagement teams as better positioned to weather the crisis and prepare for growth and recovery. The current situation plays to the strengths of larger impact fund managers, who tend to have more experience in conventional investing through downturns. We expect asset flows into impactful private market investments to continue to grow, driven by private equity managers increasingly seeking investments with stronger sustainability credentials, as these are perceived to be more resilient to shocks and resonate with investor sentiment (according to a recent report by Pitchbook).
Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments: 1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; 2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; 3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; 4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; 5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; 6) may not be required to provide periodic pricing or valuation information to investors; 7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; 8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

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- **Managed Futures:** There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- **Real Estate:** There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- **Private Equity:** There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- **Foreign Exchange/Currency Risk:** Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.
Appendix

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