

# Sustainable investing

in **European Opportunity Sustainable**

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The Concentrated Alpha Equity team give their insights on Sustainable Investing (SI) and explain how sustainability factors play a key role in their research and decision-making process for the European Opportunity Sustainable strategy.

# Why are ESG credentials difficult to prove?

The surge of sustainable equity offerings in recent years has reinforced a long-standing issue in the industry – the lack of a common definition for what is considered sustainable.

Despite regulations such as the EU Sustainable Finance Disclosure Regulation (SFDR), which mandates the disclosure of sustainability integration into investments and periodic reporting, there is no standardized framework. This makes transparency and disclosure critical for asset managers, who should be clearly articulating to clients their sustainability objectives and what they offer.

In this paper, we will walk you through how sustainability is incorporated into our investment process.

Many of the examples are based on our European Opportunity Sustainable strategy, which was repositioned to Article 8 with a Sustainability Focus in February 2021, after having fulfilled the necessary sustainability requirements by the end of 2019. As of 31 August 2021, the fund is awarded 4 Sustainability Globes by Morningstar and is rated AAA by MSCI.



# Are company ESG ratings useful given the lack of consistency?

ESG information is subjective in nature.

In a paper by Berg, Florian and Kölbl, *Aggregate Confusion: The Divergence of ESG Ratings (2020)*, it was stated that correlations between company ESG scores by major rating agencies are on average 0.54 and range between 0.38 to 0.71. Therefore, since the end of 2017 we have been using several sources when monitoring company ESG scores, including MSCI, Sustainalytics and UBS-AM. In doing so, we believe that:

- The greatest sustainability risks can be identified when several ratings consistently score poorly.
- We obtain a more holistic view of the overall sustainability risks that a company faces.

- We can identify where the differences in scoring lie and consider the various “opinions” of rating providers.

This framework was further jointly developed by the UBS Asset Management Sustainable and Impact Investing (SI) and Quantitative Evidence and Data Science (QED) teams into a multifaceted dashboard (“UBS ESG Risk Dashboard”), which was implemented in 2019. The dashboard combines multiple internal and external ESG scores and serves as a proprietary risk tool for investment teams across UBS-AM to flag companies with elevated sustainability risk.

## Proprietary UBS ESG Risk Dashboard (for illustrative purposes only)

Company	Sector	ESG Risk Signal <sup>1</sup>	Sector-relative ESG risk		Identification of “Outliers”	
			UBS ESG Consensus Score <sup>2</sup>	Absolute ESG Risk <sup>3</sup>	Governance Risk <sup>4</sup>	Controversies <sup>5</sup>
A	Life & Health Insurance	● No	4.0	Medium	8.2	Pass
B	Retail – Consumer Discretion	● Yes	3.7	Medium	0.0	Pass
C	Interactive Media & Services	● Yes	6.5	Severe	1.5	Fail
D	Technology Hardware, Services	● No	4.2	Medium	10.0	Watch List
E	Diversified Consumer Services	● Yes	2.1	Low	5.0	Pass
F	Software & Services	● No	9.3	Low	10.0	Pass
G	Beverages	● Yes	1.6	High	3.0	Pass
H	Retail – Consumer Discretion	● No	3.4	High	4.0	Watch List

Source: UBS Asset Management, as of September 2021. The table above does not represent the full coverage of the UBS ESG Proprietary Risk Dashboard.

1. Scale: yes/ no; 2. Scale: 0-10 with 10=best ESG score; 3. 5-level scale from negligible to severe; 4. Scale: 0-10 with 10=best G-score; 5. Scale: Pass/ Watch List/ Fail

# What happens if a company is not covered by the ESG Risk Dashboard?

While the UBS ESG Risk Dashboard consists of scores for over 10,000 companies globally, there may be cases where some companies are not within its coverage.

Below is an example of where we invested in a recently publicly listed company due to its strong ESG potential despite it not being covered by any ESG rating agencies.

## **Case study 1: A leading manufacturer of charging stations for electric vehicles (EVs) without ESG rating coverage**

- This company IPO-ed in October 2020 and, therefore, is not yet rated by any ESG rating providers.
- The company is an established EV technology charging pure-player that provides a “one stop shop” service for customers including hardware and software solutions ranging from planning and installation to maintenance.
- It also offers both AC and DC charging stations, which are the first on the market that comply with German calibration regulations.
- Why we like the company:
  - Leading sustainability efforts on the global transition to clean energy in the transport sector.
  - Well positioned to benefit from structural growth in the shift to EVs.
  - Supported by EU government given the continued push for e-Mobility.
  - Product differentiation and technological advantage through its proprietary software technology and strong R&D focus.



# What sets us apart if all we do is rely on ESG scores like everyone else?

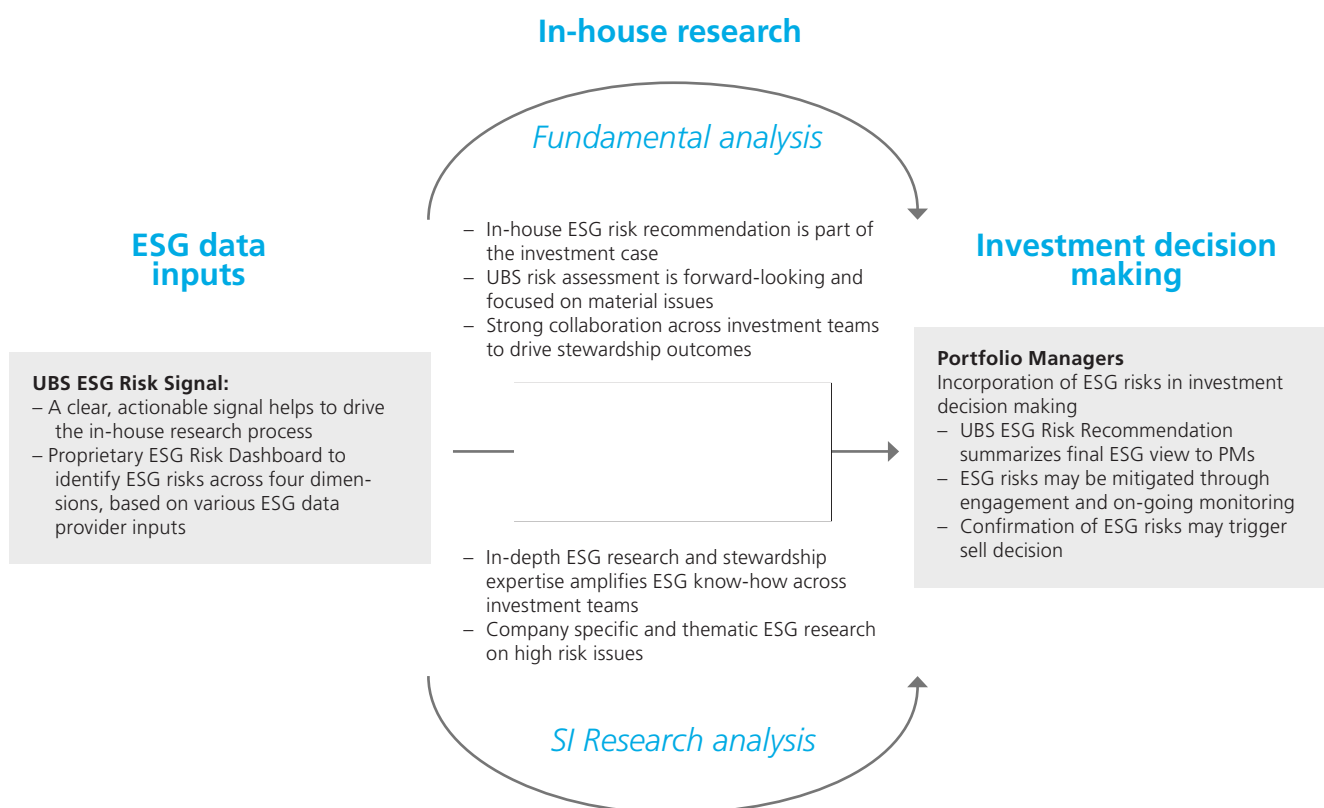
The UBS ESG Risk Dashboard serves as a starting point and, more importantly, does not result in hard constraints such as exclusions.

We do not rely solely on company scores for one-dimensional screening of companies. Instead, we are supported by the UBS-AM SI team of over 15 sustainability experts, who are dedicated to research, stewardship activities and product innovation.

For companies that are flagged in the dashboard for elevated sustainability risks, we collaborate with the SI team and other UBS-AM investment teams, including over 70 equity portfolio managers and analysts, to understand in more detail the severity of the issue and the ESG risks involved.

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## Quantitative ESG scoring supplemented by independent qualitative research




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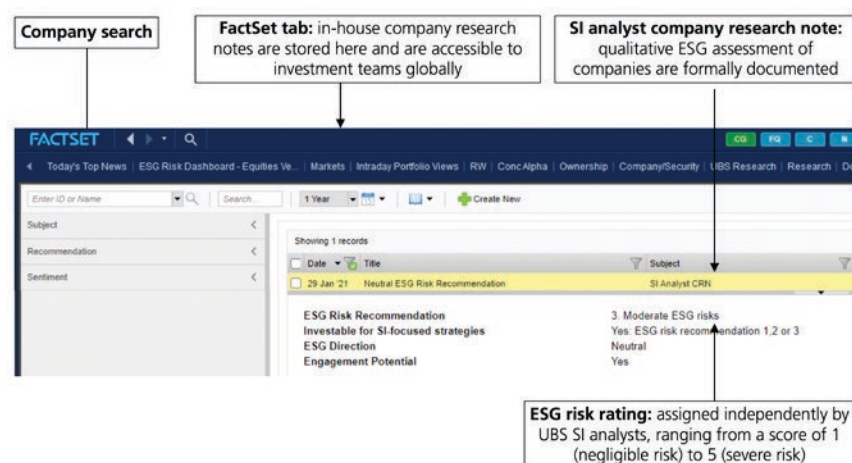
Source: UBS Asset Management, as of 30 June 2021.

# How is our investment thesis supported by independent ESG analysis?

Firstly, all company research notes are loaded into a global research management system – FactSet IRN, which allows in-house research to be stored and searched by analysts and portfolio managers around the globe. This communication platform helps us to make well-informed investment decisions as we have instant access to our enormous reservoir of in-depth proprietary research.

The case study below highlights a company that was flagged for elevated sustainability risk. The company was subsequently reviewed independently by our SI analyst team, who assigned a risk rating for the stock and formally documented the ESG thesis in a company research note. We decided to keep our position and engage with the company as we do not believe that its low ESG rating is justified.

## Documentation of company research note



Source: UBS Asset Management, as of 31 August 2021. For illustration purposes only.

## Bioethanol producer with limited ESG disclosure as a subsidiary of a larger group but without any major risks

- **Identify:** The company received a risk signal on our ESG Risk Dashboard as a result of a low consensus score and an absolute risk rating of “severe”. This is mainly a result of limited ESG disclosure given its role as a subsidiary of a larger group.
- **Review:** Overall, the company’s governance is consistent with a subsidiary of a larger firm, and the majority of the board comprises nominees of the parent group. While there are residual governance risks in this situation, we do not consider these to be large enough to justify a risk flag. All of the company’s ethanol plants are certified in accordance with at least one of the sustainable certification systems recognized by the European Commission and are audited on an annual basis.
- **Decide:** Operationally, the company faces challenges in terms of improving its carbon and water intensity but it comes under the sustainability policies of its parent company that is absent of major controversies. 69% of the company is owned by the parent group, which is free of ESG risk signals. We believe that the overall situation of the company is better than indicated by the ESG risk signal.
- **Mitigate:** To engage with the company to evaluate the strength of their ESG risk management practices and shared best practice examples, including of their peers, to enhance ESG disclosure practices. They were also encouraged to be clearer about their ambitions for increasing the sourcing of renewable energy and reducing carbon intensity.

# How do ESG considerations impact our overall portfolio construction?

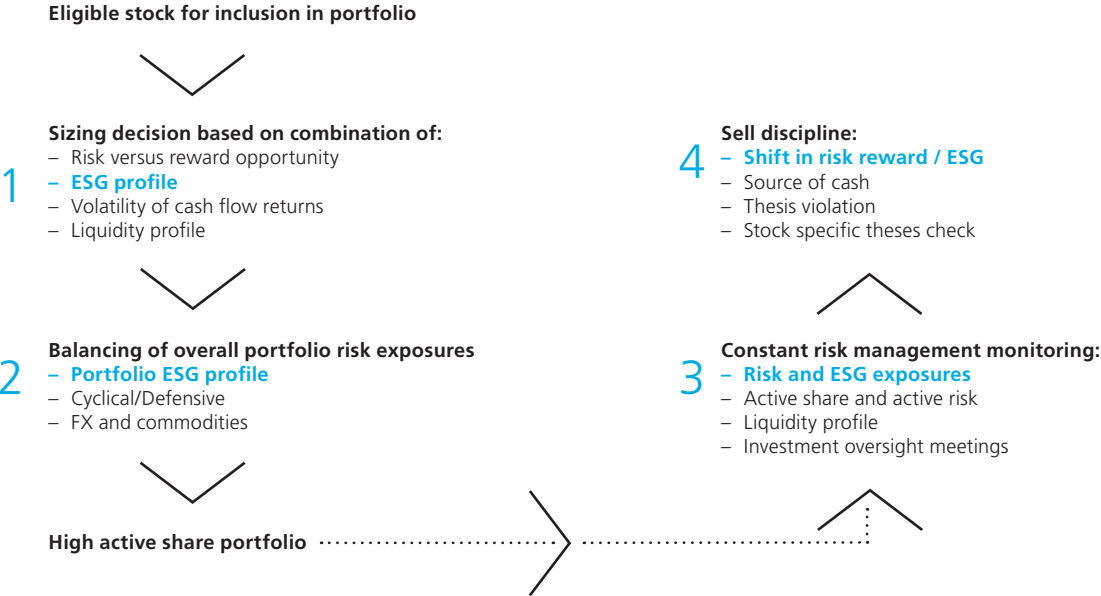
ESG factors are taken into account at multiple stages throughout our investment process and directly feed into our decision-making.

For a new idea, a stock that flags as high risk is unlikely to be a suitable candidate for the portfolio. However, as we saw with the case study above, we can still invest in a company if independent analysis shows that the ESG score assigned by

rating providers is not a true reflection of its ESG profile, or if the company demonstrates the willingness and the ability to take meaningful measures to improve.

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## Portfolio construction and risk management




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Source: UBS Asset Management, as of 31 August 2021. For illustration purposes only.

**1. Company ESG profile** – one of the factors influencing sizing decision

Exposures to individual securities will typically range between 1-3%, depending on a variety of factors including risk vs. reward, liquidity, volatility of cash flows and sustainability

factors. All else equal, a company with a stronger or an improving sustainability profile will likely warrant a larger weight in the portfolio. This information is stored within our proprietary UBS ESG Risk Dashboard as described in earlier section.

**Example of a larger holding with higher ESG scores: ASML**

Name	Ticker	MSCI IVA Industry	UBS ESG risk flag	UBS ESG consensus score	Absolute risk (Morningstar, Sustainalytics)	Governance (ISS, MSCI)	Controversy (MSCI)
ASML HOLDING	ASML	Semiconductors and...	No	9.2	Low	10.0	Pass

Source: UBS Asset Management, as of 31 August 2021. This should not be construed as a recommendation to buy or sell any particular security.

**Example of a smaller holding with lower ESG scores: Alfen**

Name	Ticker	MSCI IVA Industry	UBS ESG risk flag	UBS ESG consensus score	Absolute risk (Morningstar, Sustainalytics)	Governance (ISS, MSCI)	Controversy (MSCI)
ALFEN LV	ALFEN...	Electrical Equipment	No	4.6	High	3.3	Pass

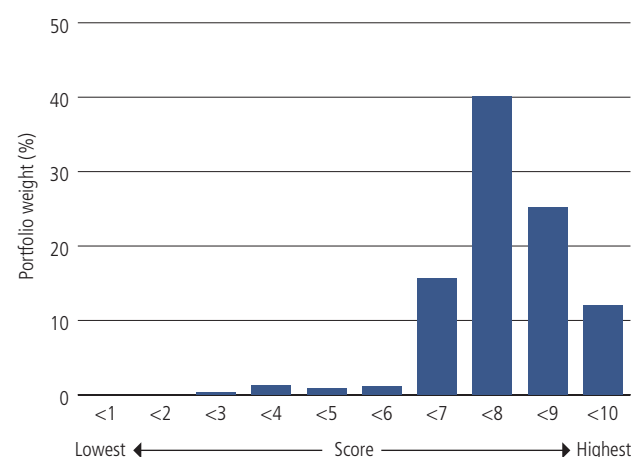
Source: UBS Asset Management, as of 31 August 2021. This should not be construed as a recommendation to buy or sell any particular security.

**2. Portfolio ESG profile** – one of the checks for overall portfolio risk exposure

We monitor the progress of our strategy based on the ESG consensus score, which is ranked from 0 (highest risk) to 10 (lowest risk). As of 31 August 2021:

- 94% of our holdings rank above the average ESG consensus score of 5
- The strategy has a higher weighted average ESG consensus score of 7.65 vs. the MSCI Europe index of 7.46

**European Opportunity Sustainable: weight distribution by ESG consensus score (%)**



Source: UBS Asset Management, MSCI, Sustainalytics, as of 31 August 2021. The portfolio has 3.4% of stocks that do not have a rating.



**3. Risk and ESG exposures** – one of the ongoing risk assessments conducted

As part of our disciplined risk management process, we monitor not only the developments of the ESG scores of our holdings but also the overall profiles of our strategies on a weekly basis to confirm that we maintain a better sustainability profile than the index.

**4. Shift in risk-reward/ESG** – one of the factors influencing sell discipline

We regularly review our reasons for holding a stock. We may reduce the weighting or sell a stock if it has diminishing support from our independent information sources and risk/reward has shifted towards the downside, including on ESG. Alternatively, we may sell a stock if an alternative investment with similar characteristics becomes more attractive. Importantly, however, ESG related issues can be brought to our attention at any point in time via other types of information sources, such as in the form of an analyst insight or news flow. This can prompt us to take action even before changes in the ESG scores take place.

#### **Case study sell example: European financials company**

- **Identify:** While the company did not flag on the ESG risk dashboard, issues surrounding money laundering came to our attention.
- **Review:** Following news reports that the company was alleged to have been involved in money laundering activities, we monitored the developments surrounding the stock closely. It quickly became clear that the amount of suspicious transactions under investigation was substantial, leading to uncertainties around the potential size of fines, management changes, compliance costs and capital charges from regulators. Experts also reported that the company had ignored several red flags and failed to take corrective measures.
- **Decision:** The case was at a relatively early stage and a formal investigation had not yet started at that time, which made it difficult for us to draw any conclusions regarding the potential risks for the company. However, we recognized that the risks were elevated, especially given the regulatory scrutiny surrounding financial institutions. Additionally, if those risks turn out to be correct then there would be little valuation support. We decided to sell the stock to limit the downside risk.

# Governance – why do we exercise proxy votes and engage with companies?

Governance has played a key role in our process for decades. We strive to build relationships with companies to foster healthy dialogue and enhance performance on a variety of issues such as strategy, culture, corporate governance, remuneration and climate change. These are done with the aim of enhancing information and influencing corporate practices to trigger better financial performance in the long term.

Where our clients have given us the discretion to exercise their voting rights, we have a fiduciary duty to do so in their best interest. Where we have identified an issue, we will seek to discuss our concerns with the company early to minimise the potential loss of shareholder value. However, successful engagement is often not a one-time discussion and can come in various forms, from information gathering to change in company practices. Hence, its effectiveness can often only be judged over a period of time.

## **In 2020, for the European Opportunity Sustainable strategy:**

- We had 24 engagements with the companies we invested in
- We voted on 46 out of the 53 voteable shareholder meetings, where we supported management on 91% of proposals and voted against on 9% of proposals

We strive to build relationships with companies to foster healthy dialogue and enhance performance on a variety of issues such as strategy, culture, corporate governance, remuneration and climate change.

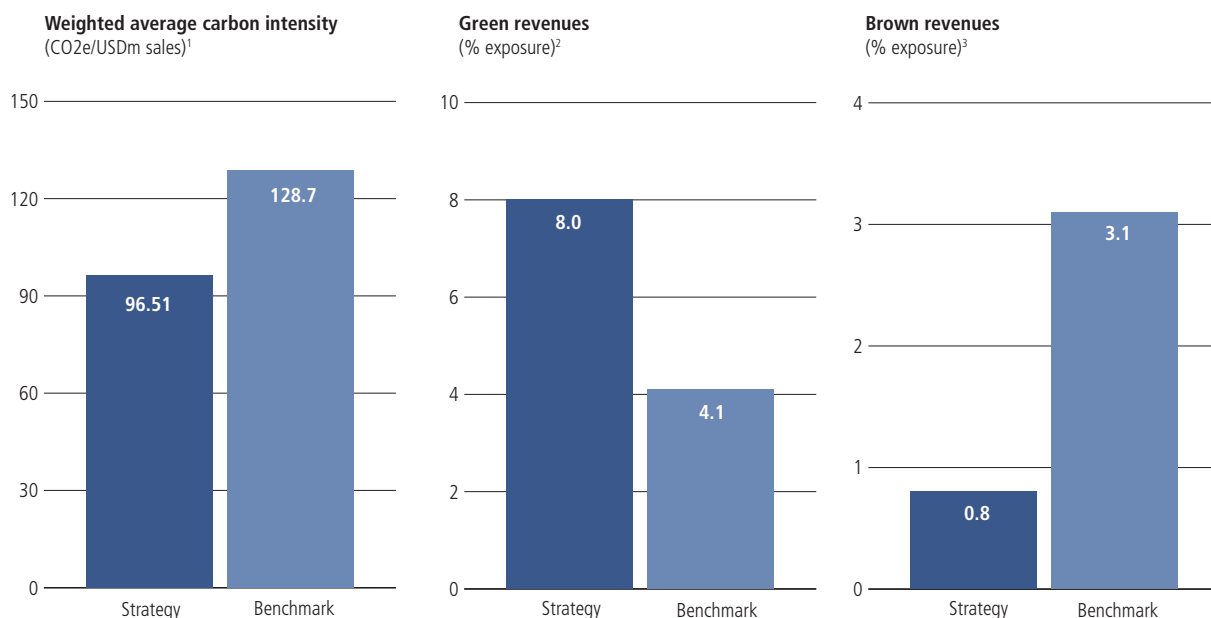
# Environmental – how are we contributing to a greener future?

The European Opportunity Sustainable strategy invests selectively in sustainable companies, including ones that are exposed to the climate change theme such as clean energy and smart mobility. In addition, we monitor the carbon intensity and proportions of revenue generated from “green” and “brown” activities respectively.

## As of 31 August 2021, the European Opportunity Sustainable strategy:

- Has a lower carbon intensity of 96.5 CO<sub>2</sub>t/m than the MSCI Europe of 128.7 CO<sub>2</sub>t/m.
- Has 2x more green revenues and over 2/3 less brown revenues than MSCI Europe.

### Climate profile comparison: European Opportunity Sustainable vs. MSCI Europe



Source: UBS Asset Management, MSCI, as of 31 August 2021.

<sup>1</sup> Carbon intensity is measured by carbon emissions (Scopes 1 & 2) per million sales generated by portfolio companies. The lower the better. Scopes 1 & 2: All direct greenhouse gas (GHG) emissions occurring from sources owned or controlled by the institution and indirect GHG emissions generated in production of electricity, heat, steam consumed by the institution.

<sup>2</sup> Proportion of revenue with exposure to “green” activities including alternative energy, energy efficiency, green building, pollution protection and sustainable water.

<sup>3</sup> Proportion of revenue with exposure to “brown” activities including thermal coal extraction, conventional oil and gas, unconventional oil and gas, oil and gas refining, liquid fuel based power generation, natural gas based power generation, thermal coal based power generation.

# Conclusion

As stock pickers our focus is on companies that offer attractive risk vs. reward according to our bottom-up investment process.

There is no better partner for sustainability than active management in our view. By allocating capital to companies with strong or improving sustainability profiles, companies with less carbon intensive business models and companies that offer alternative cleaner energy solutions, there is the opportu-

nity to contribute to a better world for future generations. By combining material sustainability data with our fundamental understanding of companies as part of our research and portfolio construction process, we believe we are equipped to make better-informed investment decisions for our clients.



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