UBS

For marketing purposes

Investing in an ESG world

A practitioner's guide

Suni Harford, President, UBS Asset Management

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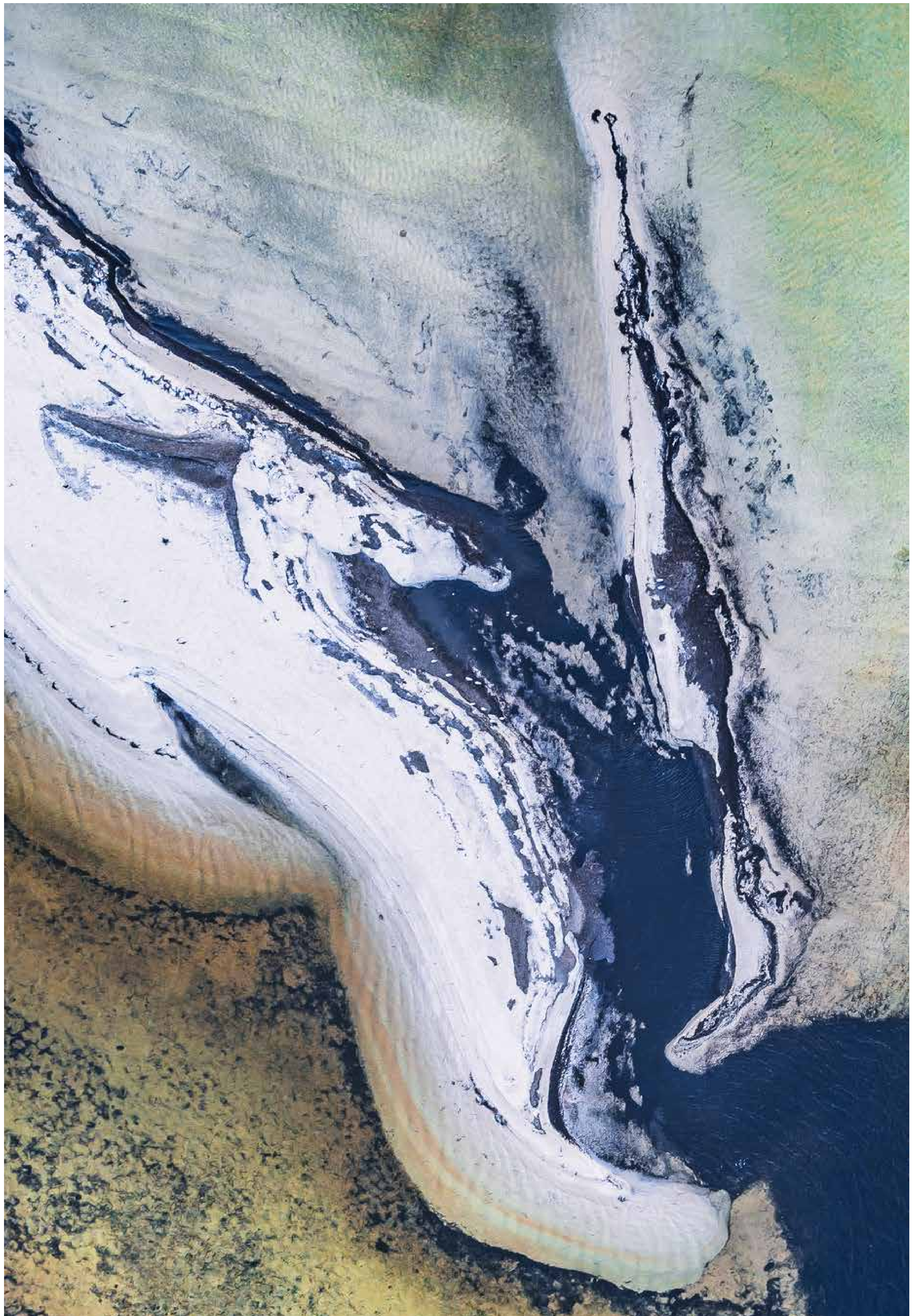


Shaping the future

> "The future is not inevitable. We can influence it, if we know what we want it to be."

Professor Charles Handy
Management Thinker and Social Philosopher

Whether or not you believe in climate change, or ascribe to what some have termed "values-based investing", any investor in today's markets must understand the effect that Environmental, Social and Governance (ESG) is having on their ability to attract capital and generate investment returns. Even a disbeliever in the long-term impact of climate change can no longer deny that there are several factors tied to this secular trend driving relative value today across the capital markets, including technical flows and regulations.

Trading is happening around the ESG discussion whether or not market participants want it to. While climate considerations have focused that discussion on the 'E' in recent years the 'S' and 'G' are coming to the fore, accelerated by the COVID-19 pandemic. To that end, UBS intends to leverage the significant amount of information available about climate and climate risk to identify what we believe is only the beginning of the trend toward sustainable investing. In this way we aspire to provide guidance on how today's investor can consider the appropriate level of diligence around the topic.

And while climate action may be just one of the 17 UN Sustainable Development Goals (SDGs), it's the one that has generated the lion's share of the factors noted above: technical demand, broad based regulatory response, and enhanced analytical capabilities.

Going back to the days of Graham and Dodd's Securities Analysis (1934), qualitative factors were acknowledged to be material variables to investment outcomes, even if these inputs could not be precisely quantified.[1] Indeed, good governance, with its focus on topics such as board composition or executive compensation, has traditionally formed part of any robust security analysis.

1 Measure What Matters (2018), UBS Asset Management
https://www.ubs.com/ch/en/asset-management/distribution-partners/insights/white-papers/2017/measure-what-matters.html

While the spirit of ESG finds theoretical roots in this recognition, the scale of flows and regulation in the space demands more substantive progress on this front. These efforts to systematize material non-financial data, and the increasing focus on climate risk, are changing the investment landscape in a way that influences perceived company value and is of accelerating importance to investors, asset owners, and individuals.

Material changes in industry structure are revealing risks in the form of failure to adapt and opportunities presented through companies that are seizing the initiative in the transition to lower emissions profiles. Climate risk also exposes companies to physical risk if their productive assets are not sufficiently insured, their supply chain is located in parts of the world with inadequate infrastructure, or they are active in markets where we are observing near-term changes in weather conditions that endanger productive capacity.[2]

The importance of non-financial factors to business operations and the work towards quantifying these inputs is driving change in three broad areas:

- Increasing investor integration of material ESG factors and greater investor appetite across the spectrum for investment strategies that use ESG factors in their decision-making process.
- A growing focus on climate risk and adaptation, with higher investor demand for strategies that focus on a long-term path toward a lower-carbon world.
- Ever more regulation from a wide variety of authorities that are seeking to push investors toward areas where climate risk and material ESG factors are taken into consideration.

Guiding the way

We believe ESG trends are inexorable and that investors are quickly adapting to what is a rapidly-evolving landscape. This paper intends to provide a practitioner's guide to investing in an ESG world by examining four key topics:

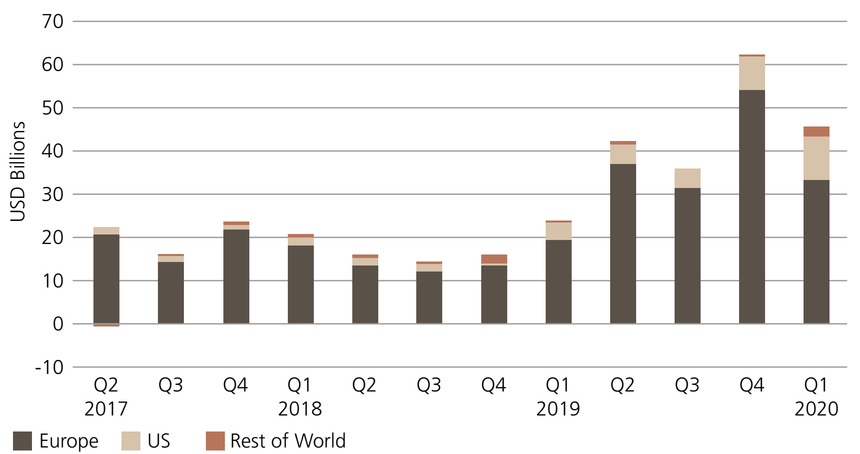
1) The accelerating and persistent flow of capital into ESG funds
2) Regulation as a driver of ESG flows, disclosures (particularly environmental), and opportunities to generate alpha
3) The role of data, both current and prospective, in ESG analysis
4) The 17 UN SDGs and their potential to accelerate ESG flows

2 Climate Change: A Risk to the Global Middle Class (2015), UBS Asset Management
https://www.ubs.com/global/en/asset-management/insights/sustainable-and-impact-investing/climate-change-form.html

Section 1

Going with the flow

Exhibit 1
Quarterly global sustainable fund flows (USD billions)



Source: Morningstar Direct, Manager Research. Data as of March 2020

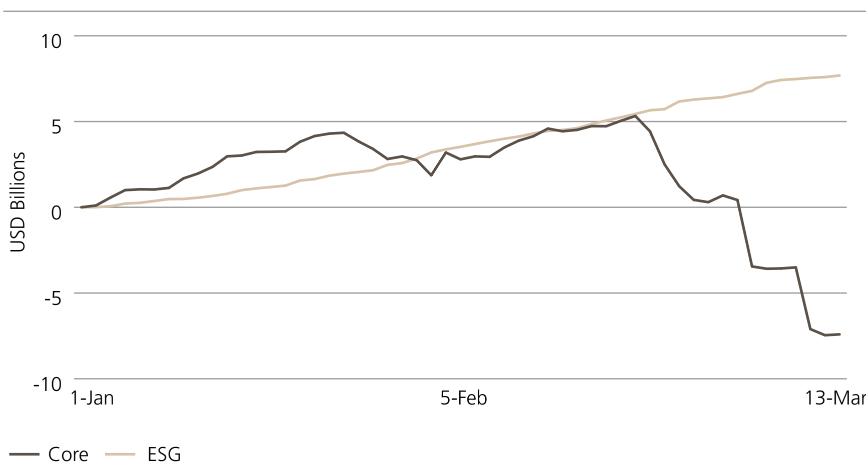
The integration of ESG into investment processes, and investors' preference for strategies that do so, has the inevitable effect of tilting portfolios toward investments that have better ESG profiles. But a lack of standardized ESG data invites debate among market participants as to what constitutes a superior profile. As allocators seek some appropriate metric for companies, perhaps the most immediate practical outcome is the commercial emergence of the Morningstar Sustainability Rating for funds which scores funds from 1 to 5 globes. Funds with a 4 or 5 globe profile (and competitive investment performance) tend to gather assets, as a University of Chicago study found. They studied US mutual fund flows before and after the introduction of Morningstar's sustainability ranking in 2016. The paper found that "... mutual fund investors collectively treat sustainability as a positive fund attribute, allocating more money to funds ranked five globes and less money to funds ranked one globe. Moderate ratings of either two, three, or four globes did not significantly attract fund flows.[3]

Taking a step back to examine the broader picture, overall, global sustainable equity fund flows accelerated in 2019, a time of outflows in the active equity space[4]. These inflows have stayed intact despite COVID-19 uncertainties thus far in 2020.

During the first quarter of 2020, sustainable funds raised USD 45.6 billion. This compared to outflows of USD 384.7 billion for the overall fund universe[5].

3 Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows (2019) Samuel M. Hartzmark University of Chicago, Abigail B. Sussman University of Chicago
4 https://www.morningstar.co.uk/uk/news/199190/record-shattering-year-for-sustainable-investments.aspx
5 Global Sustainable Fund Flows: ESG funds show resilience during COVID-19 sell-off. Morningstar, May 2020

Exhibit 2
ETF Flows Q1 2020: ESG vs traditional asset classes



Source: Bloomberg, UBS Asset Management

European ETF flows give a striking demonstration of this trend, as the chart above highlights.

For many ESG funds, this will have been their first test in a bear market environment. Early indicators suggest that these diversified ESG funds have a tendency toward defensive and quality exposures. This includes an underweight or exclusion of fossil fuel holdings, which could have strengthened their performance during a period of extreme volatility and acute pressure on commodity prices.

Where's the money?

To date, the majority of ESG AuM has been found in Europe. It's worth noting, however, the increasing momentum in US flows which reached USD 10.5 billion in the first quarter of 2020 (a new record) and remained positive in March despite the broader market risk aversion and outflows[6]. Typically, the US has lagged Europe by a significant margin when it comes to ESG adoption. There are several reasons for this, not least is the more robust regulatory requirements in Europe. The emergence of such a trend speaks to the degree to which investors are embracing ESG as a fundamental investment driver, particularly around the issue of climate risk.

While results and outcomes will vary, the disclosure of data and how investors react to it will influence portfolio composition across the active and passive space. Active investors will likely seek a better greenhouse gas (GHG) emissions profile than their benchmark; passive investors have been taking steps to tilt their portfolios toward a lower-carbon profile while maintaining market exposure. Active or passive, we believe the message is clear. Investors should pay attention to the alpha of flow that is being generated around ESG investment, or run the risk of underperformance.

6 Global Sustainable Fund Flows: ESG funds show resilience during COVID-19 sell-off. Morningstar, May 2020

Section 2

Regulation, regulation, regulation

Historically, regulation has played a peripheral role in driving investor behaviors to focus on ESG risks, but that is quickly changing.

New regulations are poised to enhance the flow of active and passive money into ESG funds by focusing more closely on disclosure that can have a visible, tangible impact on a company's financial performance. The standardization of data is also in the regulators' sights, giving investors greater insight going forward into how business operations and returns are attributable to dynamics surrounding sustainability.

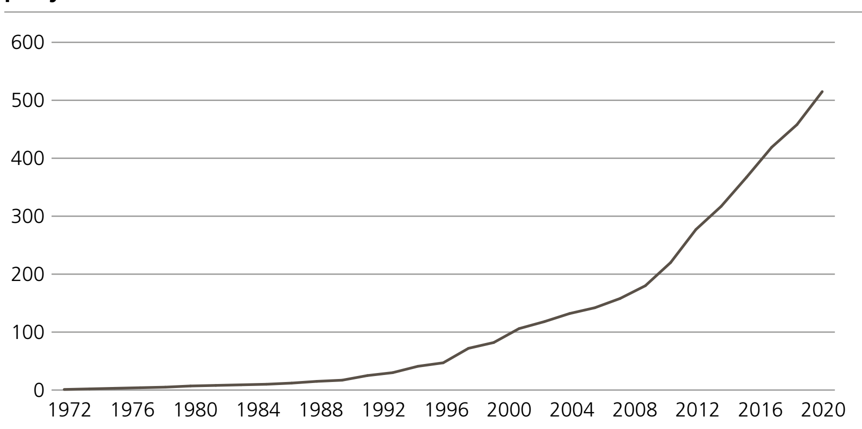
Separating the wheat from the chaff

ESG regulation has been on the rise for two decades. But EU Regulation 2088, passed in November 2019, marks an important first step in addressing "greenwashing" concerns - a reference to firms that employ misleading marketing to portray themselves as more sustainable than they actually are. From 10 March 2021 onwards, financial services sector firms will need to publish information about sustainability risk policies on their websites. Firms with over 500 employees will face even more stringent requirements. Up until now, disclosure has been voluntary, but this is changing.

According to the text of the directive, "financial market participants and financial advisers should be required to disclose specific information regarding their approaches to the integration of sustainability risks and the consideration of adverse sustainability impacts."

Disclosures will extend beyond companies and apply to products as well. If investment funds want to claim they contribute to environmental objectives, then they have to explain how they will do so. This disclosure requirement will apply for any investment fund product issued in Europe, even if the issuing firm is domiciled outside of Europe. That means investee companies, whether they're located in Europe or beyond, can expect to be asked to explain whether

Exhibit 3
The rise of regulation – cumulative number of global policy interventions per year



Source: https://www.unpri.org/sustainable-markets/regulation-map, June 2020

> “This clearly incentivizes management to prioritize these criteria in their business operations, with a corresponding benefit for investors who identify those companies that will be successful in this regard.“

or not, and how, sustainability risks are included in their investment-making or advisory process. Though a European regulation, as it seeks common cause with broader movements, like the UN SDGs and 2015 Paris Agreement, we envision other regulators taking note.

EU taxonomy

Another crucial piece of European legislation likely to influence the investment landscape in the coming months is the EU Taxonomy[7]. This is an EU-wide classification system which carries the dual aims of encouraging private investment in sustainable growth while contributing to a climate neutral economy. Effectively, it’s a push for good disclosure and long-termism in markets and economies. According to Julie Hudson, Head of Sustainable Investment Research at UBS Investment Bank, for suppliers of capital, these objectives translate as: “...a means of reorienting financial flows towards ‘sustainable and inclusive growth’; financial risk management of risks arising from global warming, as well as ‘environmental degradation and social issues’”. (*ESG Trends Op Ed: EU Taxonomy, Catalyst for a 2-Tier Market?* UBS Jan 2020)

The European Banking Authority has also said it is looking into ways to incorporate this classification system in capital requirements rules. So companies with a higher percentage of Taxonomy eligible earnings should be able to secure lower funding costs, reducing their cost of capital.

In her note, Hudson foresees three ways that this regulation will support portfolio flows:

- From short-term opportunistic investors
- ESG turnover in associated portfolios, based on their standing in regards to Taxonomy criteria
- Attempts to pinpoint opportunities with positive environmental impacts that have not yet been buoyed by any of these flows.

The regulation serves as a screening process for projects to ensure that they are operating in accordance with these ESG-tied objectives, as well as providing a uniform measuring stick for evaluating funds that support them. Investment products labeled sustainable will need to disclose the portfolio’s “Taxonomy score” at least annually and on a pre-contractual basis. As funds start to lay the groundwork for this, we should expect more commentary justifying the outperformance or underperformance of a security based on its Taxonomy eligibility. Management teams may even be influenced, at least in part, by what their Taxonomy score looks like. Just as some funds cannot own a stock unless it pays a dividend (which influences corporate capital allocation), Taxonomy eligibility could become another key consideration, thereby driving valuation re-ratings and de-ratings.

Aside from influencing the way that fund managers construct their portfolios, the Taxonomy also forms part of the Low Carbon Benchmark Regulation which benchmark providers will need to comply with. In this way we expect that the Taxonomy will help steer passive flows going forward. Finally, the European Investment Bank will use the Taxonomy as part of its measures to ensure that all of its financing is aligned with the Paris Climate Agreement by the end of 2021.

7 https://www.consilium.europa.eu/en/press/press-releases/2020/04/15/sustainable-finance-council-adopts-a-unified-eu-classification-system/

Climate-centric considerations

Elsewhere on the policy front, signatories to the UN Principles for Responsible Investment (over 2,450 investors) will be required to comply with the Task Force on Climate-related Financial Disclosures (TCFD) from 2020 onwards. Regulators are also looking to the TCFD as a framework to guide future climate reporting, given its consideration of the physical, liability and transition risks associated with climate change and what constitutes effective financial disclosures across industries.

The TCFD is best viewed as another mechanism by which management teams – and in turn, investors – can better identify the intersection of ESG risk factors and company financials. In other words, it provides a lens through which ESG can be tied to valuation.

As an example, Exhibit 4 shows an excerpt from the TCFD's guidance for companies on how to think about financial impact.

It's important to note, the TCFD isn't asking companies to set up a new risk management or governance structure. Instead, the TCFD framework is designed to be incorporated into their existing governance framework. It's meant to be decision-useful and provide improved results for corporations. At the same time, disclosure around these processes and related data is intended to make the markets more efficient and transparent, helping investors and asset owners towards a better consideration of climate risk across their portfolios.

While these regulatory initiatives look very European-focused, with an emphasis on the environment, asset managers globally need to pay attention. Europe is where many of their large scale institutional clients are located, so they won't be immune from these pressures. Furthermore, there's always the potential for Europe's regulatory present to form the foundation of future standards elsewhere in the world.

Exhibit 4
How to think about impact mechanisms – TCFD guidance
Examples of climate-related risks and potential financial impacts

Type	Climate-related risks	Potential financial impacts
Transition risks	*Policy and legal* – Increased pricing of GHG emissions – Enhanced emissions-reporting obligations – Mandates on and regulation of existing products and services – Exposure to litigation	– Increased operating costs (e.g., higher compliance costs, increased insurance premiums) – Write-offs, asset impairment, and early retirement of existing assets due to policy changes – Increased costs and/or reduced demand for products and services resulting from fines and judgements
	Technology – Substitution of existing products and services with lower emissions options – Unsuccessful investment in new technologies – Costs to transition to lower emissions technology	– Write-offs and early retirement of existing assets – Reduced demand for products and services – Research and development (R&D) expenditures in new and alternative technologies – Capital investments in technology development – Costs to adopt/deploy new practices and processes
	Market – Changing customer behavior – Uncertainty in market signals – Increased cost of raw materials	– Reduced demand for goods and services due to shift in consumer preferences – Increased production costs due to changing input prices (e.g., energy, water) and output requirements (e.g., waste treatment) – Abrupt and unexpected shifts in energy costs – Change in revenue mix and sources, resulting in decreased revenues – Re-pricing of assets (e.g., fossil fuel reserves, land valuations, securities valuations)

Source: Taskforce for Climate-related Financial Disclosure (2017): Final Report.

Section 3

Better data, better decisions

So far, it's been easy to mistrust the data self-disclosed by corporations around their climate change impact.

UBS Asset Management's (UBS-AM's) own quantitative research concluded that the out-performance from sustainability arises primarily on a risk-adjusted basis. Avoiding material sustainability risks in the portfolio can help strategies avoid companies with elevated potential for the type of event risk that can add significant headwinds to a portfolio's performance. There are also examples where product-based exclusion has turned from a historic headwind to becoming a tailwind for performance[8]. If you look at either equities or credit, the recent relative performance of ESG issuers has been positive.

Since the regulatory push is slated to provide tangible benefits and incent corporate sustainability initiatives while leveling the playing field around disclosures, back-testing based on parameters that may be outdated is becoming something that ESG neophytes might be able to safely leave in the past.

In the interim, analysts will need to work within the confines of existing data sets, at least as a starting point, in order to make an informed evaluation. So how do they incorporate a standardized ESG score which is not 'investment ready'? Third-party ESG ratings are intended to be a proxy for companies' overall net exposure to ESG risk factors. Yet we would argue that the degree to which these ratings capture the situation-specific dynamics that connect risk factors to actual financial impact at the company level is limited. Hence the input of the equity or fixed income analyst is crucial to filter the noise and apply the most material ESG information. By way of example, Exhibit 5 shows a stylized case of how UBS AM employs bottom-up analysis and information-gathering to avoid errors that might arise in a more stringent, inflexible ESG filtering and screening process.

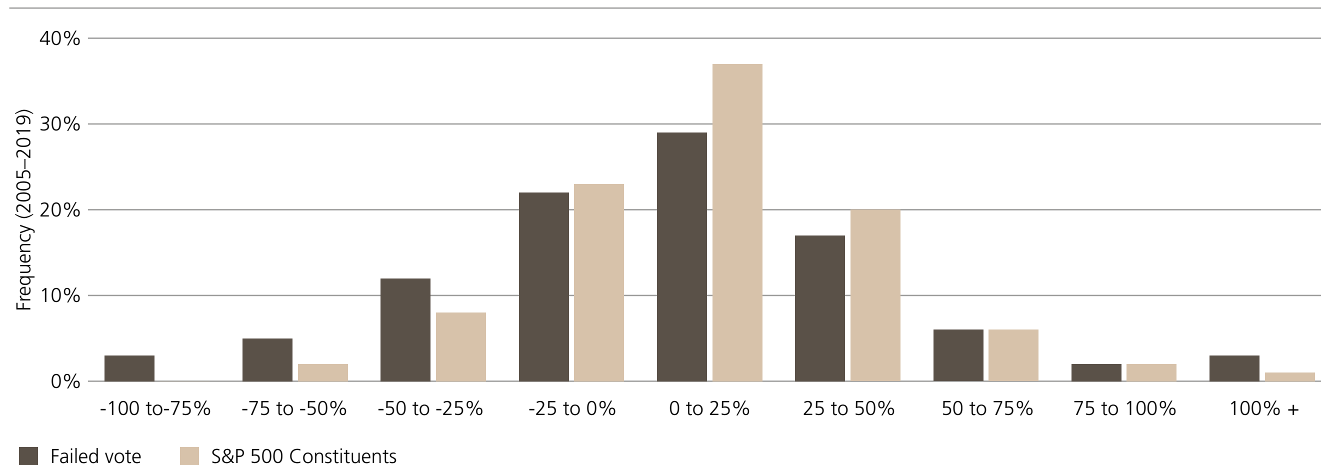
8 Norges Bank Investment Management Risk and Return Report 2019

Exhibit 5

Case study	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.

For illustrative purposes only. Not intended to be a recommendation to purchase or sell any security.

Exhibit 6
One-year total return post failed Say-on-Pay vote



Source: UBS Asset Management based on FactSet data, June 2020

Pushing the boundaries – where next for data?

With their focus on material non-financial data, we believe ESG analysts can gain significant advantage by looking beyond traditional data sets to develop a more innovative approach towards ESG data and information as sources of insight. Two UBS teams are currently working in this area – UBS-AM's QED team and UBS Investment Bank's Evidence Lab. In the following case studies the teams highlight ways in which they're working with such non-financial data to generate ESG insights.

QED insights – what can say-on-pay tell us?

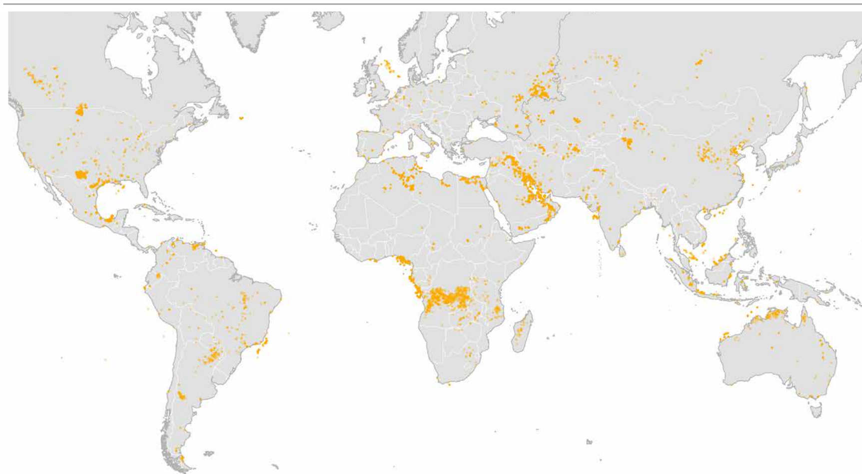
The QED team recently carried out an analysis on the back of a Morgan Stanley report (*Say-on-Pay 2020*, Mark Savino et al). The introduction reads, "Our analysis suggests that failed say-on-pay votes are a material red flag for share price underperformance". The report suggested that a negative vote on C-suite compensation leads to an relative one-year underperformance of 15% on average and the signal has been stable over the last 5 years. The vote in itself can perhaps be seen as a sign of good governance. Still, compensation reaching unsupported levels is a sign of governance issues with potential social and market consequences.

QED has tested this thesis independently on compensation-related vote data from FactSet. The dataset includes 1,700 observations from 2005 and onwards, with 95% of observations in the US. We were not able to replicate Morgan Stanley's stable signal and degree of underperformance even if the results for 2018 and 2019 are promising. However, large losses are more frequently observed for companies with a failed say-on-pay vote. Our analysis suggests that losses beyond -25% are twice as likely after a failed vote compared to S&P 500 constituents in general (see Exhibit 6). We are working on a signal that alerts investors to the heightened risk of a severe underperformance due to a failed say-on-pay.

About QED

QED's role is to drive the use and impact of data science across investment teams. As a part of this effort we review and test a lot of new datasets, often in the ESG space. We believe the current ESG data boom represents large challenges but even greater opportunities. The opportunities are well understood; high client demand for products, better investment outcomes and a positive impact on society. The main challenge is to finding the needle datasets in the haystack at offer. The QED team is constantly tracking multiple venues for new ideas, we tested a few and implement the best.

Exhibit 7
High temperature heat signatures. 10 Jun 2020 to 16 Jun 2020



Source: UBS Evidence Lab

UBS Evidence Lab

UBS Evidence Lab is committed to exploring ESG issues. Since our founding, our team of hydrologists, geographers, geophysicists, and other scientists have looked at evidence in new and innovative ways to help answer the investment questions that matter to our clients.

Highlights

Air quality has broad implications for the environment and public health. To help gauge the risk from harmful pollutants around the world, UBS Evidence Lab's Air Quality Index Monitor analyzes hourly data for over 8,000 cities. Types of pollution measured include particulate matter, carbon dioxide, and sulphur dioxide. Our Global Oil & Gas Heat Signature Monitor uses satellites to measure natural gas burning, or "flaring", at tens of thousands of oil production sites. Flaring – which is often an intentional by-product of oil extraction - releases greenhouse gases including carbon dioxide and methane.

The Employee Reviews Monitor [Glassdoor] helps gauge what employees think about their companies' governance. This dataset contains more than 3 million reviews across 7,000+ employers and shows how companies stack up on measures including satisfaction with senior management, approval of the CEO, and opinion of the business outlook.

The US Grocery Demographic Model and Regional Exposure Model help identify "food deserts", or places where low-income residents have limited access to grocery stores. The models measure household incomes vs. the national average in the markets of different retailers and show where these retailers' locations are concentrated. UBS Evidence Lab's Deep Theme Explorer bolsters thematic research by expanding a search term into a theme by statistically identifying other terms or phrases that frequently occur together with the original search term. We are currently tracking over 800 ESG related "themes" using our deep theme algorithm. These 800+ themes are expanded into 8,000 very rich topics that in turn are organized into theme clusters. There we measure positive, negative, and net sentiment as well as total mentions using a variety of sources and publications (news, earnings calls, UBS Research, blogs, industry journals, company filings) on tens of thousands of public and private companies and organizations. UBS Evidence Lab has a patent pending on the approach and client pilots of the Deep Theme Explorer are in progress.

About UBS Evidence Lab

UBS Evidence Lab is a sell-side team of experts, independent of UBS Research, that work across 55+ specialized labs creating insight-ready datasets. The experts turn data into evidence by applying a combination of tools and techniques to harvest, cleanse, and connect billions of data items each month. The library of assets, covering over 4,000+ companies of all sizes, across all sectors and regions, is designed to help investors answer the questions that matter to their investment analysis.

Beyond 'E': Looking at 'G' as a source of insight

We can extend the argument for better data by considering the growing body of academic evidence for the efficacy of ESG factors as a whole on risk and return.

Here it is interesting to look at the long arc of the 'G' factor and see what it reveals about the pertinence of material, non-financial factors.

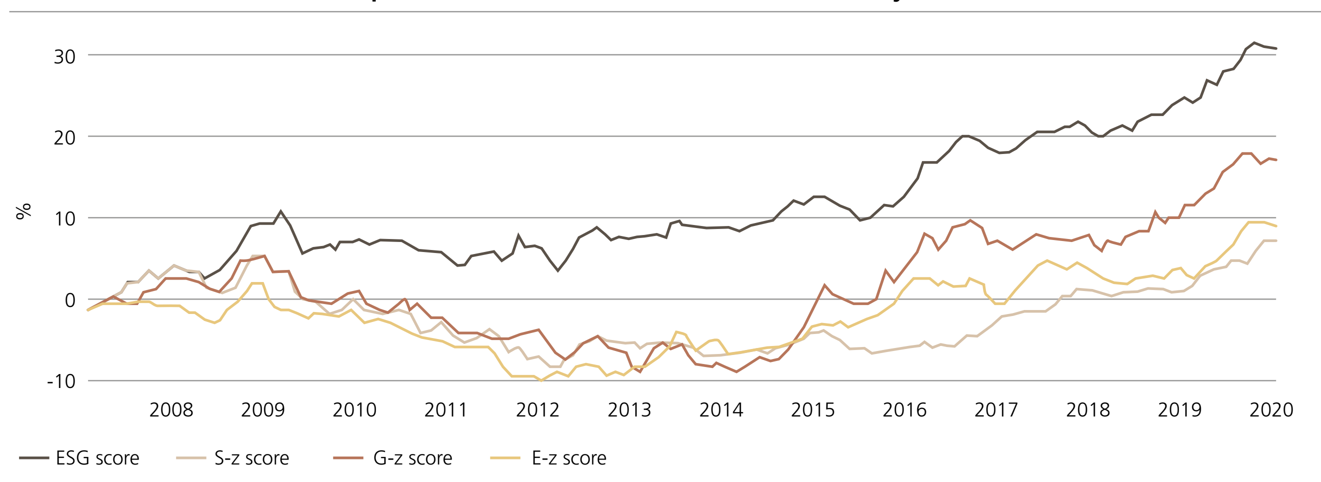
One of the earliest, and most influential, papers on this topic was published in 2003. Titled *Corporate Governance and Equity Prices* by Paul A Gompers, Joy L. Ishii and Andrew Metrick, the paper showed a positive alpha effect resulting from superior governance. Although this paper is arguably unsophisticated by current standards because today's investors look for affirmed correlations and explanations in a risk-based setting, it put governance on the map. Today it is widely accepted as a critical investment factor that must be considered when making investment decisions.

More recently, a 2020 research paper from MSCI[9] sought to break out the effects of individual E,S and G scores on performance, based on a 13-year study period. The paper highlighted the immediate impact of governance issues on share prices, making it possible to have higher levels of statistical confidence when looking at volatility or frequency of large drawdowns. By contrast, environmental and social issues tended to emerge over a longer period of time, albeit with financial effects that can be long-lasting – consider CO_2 emissions for example. Overall, the report found that the governance score was shown to have the greatest 'single pillar' variation in stock-specific risk. However, the total ESG score consistently outperformed all individual pillar scores.

Regionally, the study reveals variations across North America, Europe and Asia-Pacific. In all regions, total ESG scores outperformed single pillar scores. However, in terms of individual pillars, governance showed the greatest outperformance in Europe and Asia, but was the lowest performer relative to benchmark in North America.

Time horizon emerged as a critical factor. If an investor is looking to evaluate ESG risk on share price over the short-term, then governance issues emerge as the most financially material. But over the longer-term, a more balanced and industry specific ESG weighting proves more relevant.

Exhibit 8
Performance of Q5-Q1 Quintile portfolios in MSCI World Index (Local Currency)



Source: MSCI ESG Research LLC. Data from December 2006 to December 2019 for the MSCI World Index. This exhibit shows how the top-performing quintile (Q5) minus the bottom-performing quintile (Q1) performed for the aggregate ESG score and each individual pillar score

9 Deconstructing ESG Ratings Performance Risk and Return for E, S and G by Time Horizon, Sector and Weighting Guido Giese, Zoltan Nagy, Linda-Eling Lee June 2020 MSCI ESG RESEARCH LLC

What really matters?

So how should investors think more widely about the question of materiality? The San Francisco-based Sustainability Accounting Standards Board (SASB) maintains and publishes a widely referred to Materiality Map™, which informs the basis of UBS-AM's own ESG Material Issues Framework. Because sustainability encompasses so many topics, financial analysts and portfolio managers need to focus on a limited set of factors that can potentially affect a company's financial performance. The ESG Material Issues framework identifies the most financially relevant factors per sector that can impact the investment thesis across 32 different industry sectors. Orienting toward financial materiality can ensure that analysts focus on those sustainability factors that impact the bottom line and therefore investment returns.

The SASB's well-accepted reporting standards for ESG data have been voluntarily adopted by many companies, with some even providing these disclosures in common SEC filings like the 8-K and 10-K.

These guidelines may prove to be another instance in which the ESG pendulum swings from optional to required. Investors should take note that financial standards followed a parallel standardization path, concluding in an SEC mandate for the Financial Standards Accounting Board in 1973 and eventual global reporting standards agreed in 2002 with the International Financial Reporting Standards Foundation. Similarly, an SEC subcommittee published a memo in May 2020 calling for action on the part of the SEC Asset Management Advisory Committee on ESG reporting standards.[10]

10 Recommendation from the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure (as of May 14, 2020)

Section 4

What about the SDGs?

A paper titled Investing in an ESG World needs to consider the UN's 17 global Sustainable Development Goals that came into being in 2015, ratified by 193 countries. They address topics like poverty, hunger, health, education, climate change, gender equality, environment and social justice and carry an end date of 2030. It's estimated that achieving them will take an annual investment of USD 5 – 7 trillion between 2015 – 2030 and there is a clear expectation that the private sector will play a significant role in achieving their aims. It's been predicted that realizing the SDGs could unlock USD 12 trillion of market opportunities across four distinct economic systems[11]:

- Food and agriculture
- Cities
- Energy and materials
- Health and well-being

While a growing number of investors want to align their investments to the SDGs, they're challenged by difficulties in translating the goals into investable opportunities. Although the investors' objective is clear: to measure financial returns alongside the wider societal and environmental impact of their capital, without defined frameworks, many investors have to create their own. Hence a recent survey showed that while 25% of those polled integrate the SDGs into their investment activities, just 8% report on the impact their investments are having on the Goals[12].

This might change with the introduction of the EU Taxonomy, which we highlighted earlier in the paper as "...a means of reorienting financial flows towards 'sustainable and inclusive growth'". Why? Because as we outlined, one of its crucial characteristics is that it is outcome oriented, much like the SDGs. The UNEP FI believes that a better understanding of impact will be critical to driving ever greater quantities of capital towards sustainable finance, with the end goal of meeting the trillion-dollar financing requirements of the SDGs.

Investing with the SDGs in mind will require a long-term perspective – these are not issues which can be solved overnight. Achieving them entails the principle of continuous improvement, as much for investors as for investees. So we, and others, regard engagement as a powerful tool that can drive positive sustainability impacts over the long-term. Large scale institutional investors, and a growing number of private investors, have long recognized the value of engagement, engaging on topics ranging from climate change to corporate governance.

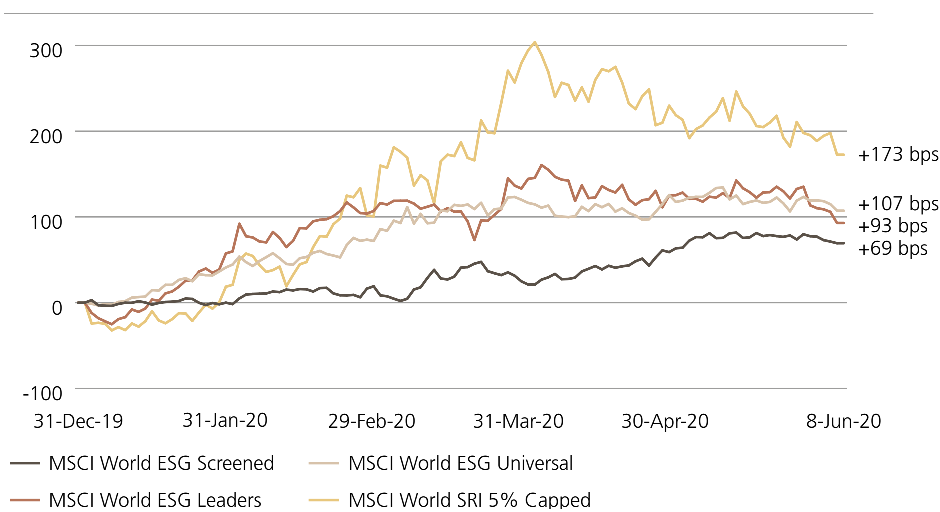
11 BETTER BUSINESS BETTER WORLD The report of the Business & Sustainable Development Commission January 2017
12 Creating a strategy for a better world: How the Sustainable Development Goals can provide the framework for business to deliver progress on our global challenges. PWC, 2019

The UBS-AM Climate Engagement program has demonstrated the impact that a clearly focused engagement can have. As a company, and through collaborations such as Climate Action 100+, we've been engaging with some of the world's largest energy producers on emissions reduction. And it is producing results. For example, Italian energy company ENI has committed to reducing its GHG emissions intensity to 80% across the entire value chain, including scope 3 emissions coming from its sold products. Elsewhere, as part of the investor coalition Climate Action 100+, we have been engaging with Norwegian energy giant, Equinor, one consequence of which has been their decision to stress test their portfolio using more ambitious climate change assumptions. They have now updated their GHG emissions reduction to 2050, including almost zero absolute emissions from their Norwegian assets.

Elsewhere, we have been engaging with a North American company in the consumer discretionary sector on governance issues. Improvements consistent with our engagement targets have been positive since the beginning of 2019, starting with a change in executive compensation by the addition of a free cash flow metric. Later in 2019, the Chair agreed to completely refresh the board by 2021. In the last quarter, the company announced a major restructuring and free cash flow jumped to its highest level in several years as changes to incentive compensation began to flow through to the P&L.

Investors can also apply engagement principles to a variety of SDGs, tracking and influencing a company's progress in aligning its business strategy to its SDG targets. We see this as an important next step for engagement: going beyond a tool that solely addresses risk, to become a driver of opportunity. By working in partnership with companies, investors can engage to find long-term solutions, build better practices and unlock value.

Exhibit 9
Excess returns vs. MSCI World TR Net in USD



Source: MSCI Inc, UBS Asset Management, data as of 8 June 2020
Please note that past performance is not indicative of future results

Where next?

This paper has been written against the backdrop of the COVID-19 pandemic, the consequences of which are profound. For investors, they provide the starkest proof of why ESG matters. The prioritization of social factors like sound business ethics or employee health and wellbeing; the role of governance factors such as effective risk management, and the importance of environmental factors as calls grow for a 'greening' of the pandemic's recovery phase – all these demonstrate why ESG is material to the investment case.

And although it is early days, the relative performance of ESG indices during the first quarter of 2020 suggests that the tendency of ESG funds to focus on more resilient companies means they are better able to withstand volatile and falling markets, reinforcing the case for ESG.

If this performance trend continues, then we would expect ESG flows to accelerate further still.

Underpinning this trend will be regulation – already a key driver of ESG integration, as we've identified. In the aftermath of COVID-19 we could well see regulators intensify their scrutiny on the ways in which ESG risks more broadly are integrated within the investment process, meaning investors have even less opportunity to shy away from ESG. If so, then that will place a greater emphasis on better data, quite possibly encouraging the adoption of a wider and more innovative range of data sources which can give a more complete picture of where the risks and opportunities lie.

Indeed, with the dual drivers of performance and regulation, one could foresee a state where institutional investors choosing not to integrate ESG find themselves in dereliction of their fiduciary duty.

Last, but not least, the COVID-19 crisis has exposed the weakness of our global interdependencies. As UNEP Executive Director Inger Andersen said, "The outbreak will have profound and lasting economic and social consequences in every corner of the globe."[13] It will therefore be crucial for the recovery to strengthen those interdependencies, not just economically but socially as well. Here the 17 SDGs can offer a valuable framework on which to build back better, touching as they do on the many facets of the pandemic, from good health and wellbeing, through good education and reduced inequalities, to climate change.

For too long, economic development and financial market priorities have not been aligned with sustainability. This short-sightedness has allowed risks like those created by climate change to grow. The silver lining is that the scale of the global repercussions brought about by these issues necessitates harnessing the power of finance to be part of the solution.

If anyone had any doubt as to the value of ESG before the pandemic, there can be in little question in their minds now. We are standing on the cusp of a transformation in the capital markets. Our world has become an ESG world.

13 https://www.unenvironment.org/news-and-stories/story/covid-19-four-sustainable-development-goals-help-future-proof-global

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