

Unlocking insights

Brave new world | Megatrends and long term themes:
sustainable investing for the future has come of age



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Bruno Bertocci is a managing director and senior portfolio manager at UBS Asset Management who has been developing and providing sustainable investment solutions for clients at UBS for over 10 years. We sat down with him recently to discuss how the Long Term Themes (LTT) investment strategy is constructed to take advantage of challenges and opportunities that are arising from massive global developments that will inevitably shape the future of our societies and economies.

Q: First and foremost can you give us an overview of the Long Term Themes investment strategy?

A: The LTT strategy is a collaboration between UBS Asset Management (UBS AM) and the CIO Americas, Wealth Management (CIO Americas, WM). It is a solution for investors interested in a long-term portfolio of companies that have excellent valuations based on both traditional financial measures and on material sustainability criteria.

The CIO's research team has been delivering research on three key megatrends—population growth, aging and urbanization—and 19 related sustainable long-term themes. These are trends in economic growth, social and demographic changes that are in place now and that should continue to play out over a very long time, such as the need to improve energy efficiency, waste management and healthcare in emerging markets.

These themes may drive how people live, how the global economy and ecosystem evolves and how companies in certain industries will prosper or fail. Understanding these themes and these companies, and incorporating the increasingly available non-financial environmental, social and governance data into investment decisions, can be integral to making informed decisions about companies and portfolios. The CIO Americas, WM research and UBS AM's more than 20 years of experience investing in sustainable equities and employing our proprietary, multi-stage, forward-looking cash flow model combined with ESG data integration, translates into an implementable investment thesis.

The LTT portfolio brings together two important and unique capabilities of UBS—our proprietary thematic research and sustainable equity investment capability—into a single solution that we believe can generate long-term results for our clients.

Q: How do Wealth Management and Asset Management work together to create this unique solution for clients?

A: Population growth, aging and urbanization are three inexorable trends that are reshaping our societies. They represent huge adaptation challenges that the CIO Americas, WM, through extensive research, defines as 19 themes. This research results in a “shopping list” of companies whose products and services are solutions to the megatrend challenges and may be poised to grow and benefit as a theme evolves. Every stock on the list has a meaningful amount of revenue, 20%, at the least, and typically more, that is associated with one or several themes due to a business model that solves a problem and delivers a product or service that we expect will become increasingly important as the megatrends progress. The revenue component is essential, because at the end of the day we are looking for companies that are going to experience growth in their business and in their earnings.

It is UBS Asset Management's job to look at the 800 or so names on the thematic shopping list from our own bottom up perspective. We analyze traditional fundamentals, estimate valuation and dig into sustainability metrics to build a sensible global portfolio of companies that have a strong sustainability profile and attractive valuation. The LTT portfolio brings together two important and unique capabilities of UBS—our proprietary thematic research and sustainable equity investment capability—into a single solution that we believe can generate long-term results for our clients.

Q: In this new world of tangible and intangible assets, how does UBS value companies from the bottom up based on their distinct business attributes?

A: When we talk about valuing a company, we're really talking about the intrinsic value of the security in a traditional Graham and Dodd, Security Analysis sense. The market has put a stock price on a company, but what is its long-term intrinsic value? Would we buy the entire company if it was available? Of course we consider the value of traditional tangible assets. When Graham and Dodd wrote their ground-breaking book in the 1930s most companies were made up of brick and mortar: tangible asset metrics explained almost all of the market value and companies were priced closely to book value.

Today two thirds of all businesses are service companies, which are “asset light” or nearly asset free. Tangible assets explain a shrinking proportion of the market value of companies. Modern sustainable investing helps evaluate intrinsic value from a broader perspective. What you are paying for when you buy the whole company is a mix of tangible and intangible assets. Intangible assets are valuable, but they are not reflected on the balance sheet and new metrics are needed to value them. Think of it as Graham and Dodd 2.0: Modern sustainable investing is about enlarging the scope of the analytical framework because of the way companies are organized and operate today.

Q: What is your equity valuation framework?

A: Company analysis is no longer just about the financial statements. Book value in most equity markets accounts for less than a quarter of the typical company's market value. There are a lot of other factors related to ESG components of sustainability that can have a major impact on a company's operational success,

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such as, brand, customer loyalty, supply chain, shared value, etc., and we see this effect on share prices and in the news every day.

The way we view the analytical process when we select stocks, when we're coming up with an intrinsic value for a company, is that we're still projecting future cash flow and calculating its present value, but that cash flow is being generated by a combination of the tangible and intangible assets.

Q: Why is it important to look at non-financial data relevant to a company's business plan?

A: Looking at the financials of a company is only the beginning of the story, not the end, because there are so many other material aspects to a company's business that contribute to its intrinsic value. That can depend on the industry and the business model. Good governance determines whether the management is creating value for the shareholders: that is universal. However, depending on the industry there are many other inputs that matter. If the company has a supply chain, supervision and management is a key competitive factor; factory safety can help create superior products; the ability to keep and attract talent can drive innovation, and so on.

For instance, think about energy-intensive companies or companies with connections to suppliers that are dependent on energy and that are making efforts to improve their footprint—adapting their businesses to be less carbon reliant. They may be more successful due to compliance with increased regulation (such as carbon taxes), access to cheaper sources of energy, brand recognition, shared value with consumers, and even their supply chain. An energy-intensive aluminum company could find itself at a disadvantage to one with access to a cleaner and cheaper energy source.

Q: How do you build the portfolio?

A: In the LTT strategy the thematic composition of the portfolio is an outcome of the stock selection process and not the other way around; we think that's critically important. We do our own independent company assessment, with independent sector analysis: we own every part of the logic chain and the value chain of the decisions we make about the companies we buy.

When the CIO Americas, WM research team identifies the stocks associated with the Long Term Themes, they are not making a statement on their valuation, they are confirming that they have significant revenues associated with a theme. So there can be a theme comprising stocks that are not attractively valued at the moment, which means the timing is not right for inclusion in the LTT portfolio. The UBS AM Global Sustainable Equities team focuses on picking stocks that are attractively valued and that rank well on material sustainability factors, and then build a sensible global portfolio of 40 to 80 names that has appropriate active risk exposure with the goal of generating an excess return.

Some thematic funds that are built from the top down without regard to valuation or risk can result in a less than ideal experience for clients. If there is a sector that's not attractively valued we're not going to buy it now; we're going to be patient and wait until valuations improve.

We track approximately 80 factors across industry groups and our sustainability score is integrated into our portfolio construction and risk management tools.

Q: What does UBS AM's global equity platform look like, and what makes it unique?

A: Our proprietary UBS ESG Factor Model tracks and scores companies broadly on governance structures and policies and on environmental and social key performance indicators (KPIs) that we believe are material and industry specific. We've been involved with and supporters of the Sustainability Accounting Standards Board (SASB) for a long time, especially by participating in SASB's undertaking to define industry specific metrics for sustainability reporting. SASB's effort to identify the most material KPIs that are specific to an industry is leading the way toward uniformity of reporting and disclosure. Our UBS database is informed by SASB's Materiality Map™ and its focus on material metrics.

For example, measuring a company's energy efficiency matters if it is a manufacturing company but it's mostly irrelevant if you're looking at a software company. And these metrics don't just apply to a specific company, but also to its supply chain. Supply chain management is emerging as one of the most important metrics for asset light companies.

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Q: As sustainable investing is becoming main stream, are there typical principles that you are applying to your portfolio construction?

A: We're using UBS AM's portfolio construction and risk management tools to help determine that the active risk in the portfolio is driven by the idiosyncratic or stock-specific space, not countries, sectors or common factors, and we have controls in place for that. We manage a high active share portfolio (with a target of 90%) because we are stock-pickers. We also aim for an active risk (the difference in the risk in the actively managed portfolio versus its benchmark, or tracking error) that typically ranges from 4%–6%, with the bulk of that coming from stock selection. I can't emphasize enough that ESG and Long Term Themes investments are implemented in a portfolio of stocks that are carefully selected from the bottom up with particular emphasis on the valuation of the stock price and high level of sustainability. We believe that this approach will help us identify long-term winners to provide attractive returns for our clients.

Q: Why should investors consider an allocation to the Long Term Themes strategy?

A: We are bringing together two of the best capabilities of UBS in one portfolio: strong top-down thematic research and rigorous bottom up stock selection. Whether our clients are interested in having a positive impact on the environment or corporate culture; looking for a strategy that can be part of a long-term allocation for retirement or building a legacy; or believe that sustainable investing is simply smart investing, the LTT strategy can play a key role in their financial planning.

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