Asset management
Professional clients only

Long-term value creation

Sustainable investing for Sovereign institutions

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Sustainable Investing has grown rapidly over the past 10 years. However, its emergence as a key topic among larger institutional investors, including Sovereign Wealth Funds (SWFs) and other Sovereign institutions, has been relatively recent.

Historically, a major challenge for institutions has been that many sustainability-focused providers have tended to be smaller boutique asset managers. This is now changing. Larger, global asset managers are starting to develop new and innovative solutions to meet the sustainable investing needs of their institutional clients. While this represents an historical development in finance, it also requires a new understanding of the nature and goals of sustainable investing, one which is better suited to the needs of institutional clients.

In this paper, we examine the ways in which larger investors can successfully approach sustainable investing, and in particular, why sustainability is so relevant for Sovereign Wealth Funds and central banks. We set out a framework and suggest various strategies that are needed to drive sustainability in such a way that it meets the needs of larger institutions that may not have previously incorporated sustainable investing within their overall investment approach.

We start by outlining the limitations of previous approaches to sustainable investing, typically through negative and positive screening.

In our view, a better approach for mainstream institutional investors is to understand sustainability in terms of long-term investing. We conclude with some examples of the ways in which UBS Asset Management has worked with larger institutional clients to implement responsible investment strategies that help them meet both their financial and sustainability requirements.

Research shows clear investor expectations

$10tn

120 investors with over $10tn have signed the Montréal Carbon Pledge[1]

CalPERS

will require all of its managers to identify and articulate ESG in their investment processes[2]

69%

UHNW Millennials interested or very interested in Socially Responsible Investing[3]

$62tn

AuM managed by signatories to the Principles for Responsible Investment[4]

€2.2tn

Dutch Financial Institutions made an explicit commitment to use the UN Sustainable Development Goals (SDGs) framework[5]

78%

of asset owners surveyed consider ESG management to be one of the top 5 issues when choosing an asset manager[6]

85%

of asset owners review a manager's RI policy, and over 60% assess ESG incorporation strategies and ability to identify and manage ESG issues[7]

1 www.montrealpledge.org
2 Top 1000 Funds, May 2015
3 Campden 2015 UHNW Millennials Research report
4 PRI Annual report 2016
5 Dutch SDG Investing (SDGI) Agenda
6 Responsible Investor, Asset Owner Survey 2015
7 Principles of Responsible Investment, PRI Report on Progress 2015

Screening approaches to Sustainable Investment

Despite impressive growth rates, sustainable investing has faced difficulties in entering mainstream investment strategies. This is only just starting to change. In part this has been due investors' misperceptions – a belief that sustainable investment limits choice and compromises a client's primary financial objectives. This view arose from more traditional sustainable investment strategies that used a combination of negative and positive screens in order to select companies for an investable universe.

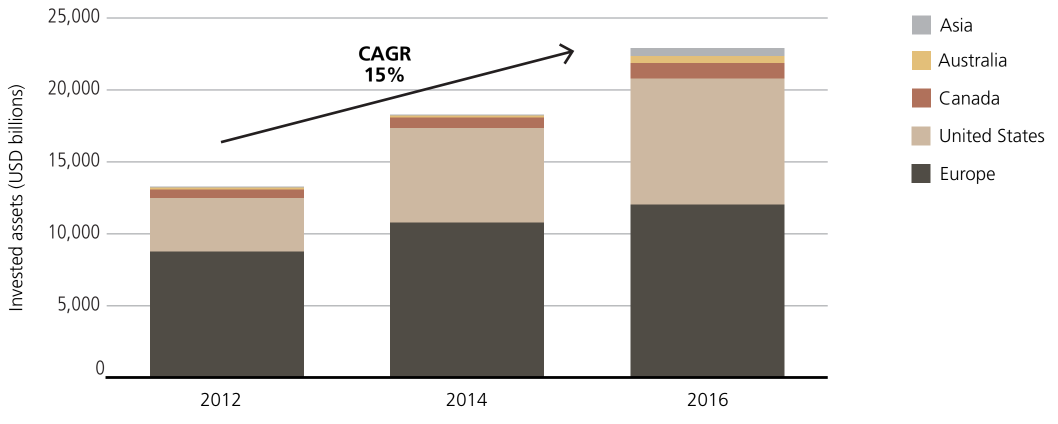
Negative screening of funds has been pursued by faith investors since the 19th century, but it was not until the 1980s and the emergence of "SRI" investing as a means of divesting from companies involved in supporting apartheid in Africa that it gained widespread attention.

While negative screening provided an initial strategy for early socially responsible investment funds, it does not provide a sound basis for moving sustainable investment into the mainstream. First, negative screening criteria reflect the ethical requirements of particular clients. There is not normally a common set of ethical standards across all clients that can serve as the basis for a broader approach for mainstream integration. Second, avoiding companies engaged in certain practices fails to impact these companies themselves – it may even encourage unsustainable practices by transferring ownership to those who are unconcerned about sustainability. Third and most importantly, excluding sectors or stocks on ethical grounds provides no financial benefit to the investment strategy. On the contrary, it could harm long-term returns by limiting investment options. Negative screening perpetuates the belief that sustainable investing restricts choice based on ethical principles. It is therefore important to move beyond negative screening to establish a firmer foundation for mainstream investment strategies.[1]

In response not just to these issues, but also the rapid growth in corporate sustainability disclosure, a focus on positive screening using Environmental, Social, and Governance (ESG) emerged in the 2000s.

Positive ESG screening had the advantage of being additive to the investment process. It allowed investors to establish a systematic approach to identifying those companies which demonstrated high quality management and it had the ability to mitigate various sustainability risks. Over the past decade, positive screening has also provided the basis for a significant growth in the market of "best in class" sustainability funds and Indices.[2]

Growth of Sustainable & Responsible Investment



Source: US SIF; The Forum for Sustainable and Responsible Investment. From the 2016 Report on Sustainable and Responsible Investing. Global Sustainable Investment Alliance, 2012, 2014 and 2016 Global Sustainable Investment Review ; Eurosif

1 For more on this common perception of sustainable investment as hindering mainstream adoption, see OECD, "Investment governance and the integration of environmental, social and governance factors" (2006), p. 12. www.oecd.org/cgfi/resources
2 For an overview of the growth in positive screening funds, see the latest survey of the SRI market by the European Social Investment Forum,: www.eurosif.org/sri-study-2016

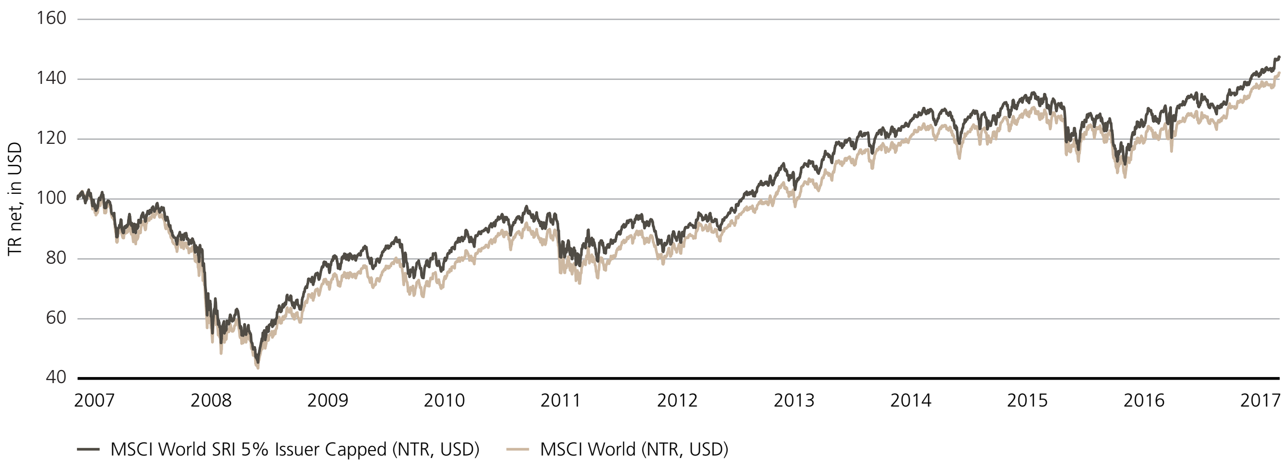
While positive ESG screening has been an important step forward in the evolution of sustainable investment, in isolation it is inadequate as an approach for larger institutional investors. There are several reasons for this.

First, the reported ESG data used for positive screening is based on risk management performance metrics. However, it generally lacks the information needed to address the positive external impacts of companies' products and services. These represent not just a company's most important sustainability impacts, they also drive a company's financial success through sales growth over the long-term. Second, although ESG data has added an important basis for analyzing a company's risk, the link between sustainability data and alpha generation has not been consistently demonstrated.

Nonetheless, most surveys of academic studies on the topic have, importantly, concluded that sustainable investing does not harm returns, and there is evidence that sustainability integration can help to lower the cost of capital and mitigate downside risks.[3]

Finally and perhaps most fundamentally, ESG screening has remained independent of financial analysis and research. This is evidenced by the fact that most ESG ratings and research are conducted by third parties. For sustainability to truly enter the mainstream, it will need to be adequately included in the financial models and recommendations used by mainstream asset managers. In short, a new and more adequate understanding of sustainability is required to serve as a basis for mainstream sustainability integration going forward.

MSCI World SRI 5% Issuer Capped vs. parent index



Data from 28 Sept 2007 to 28 Sept 2016.
Source: MSCI, UBS Asset Management
Past performance is not an indicator of future performance

3 For a summary of recent academic literature, See UBS Global Research, "Academic Research Monitor: ESG Quant Investing," 14 December, 2016. For a comprehensive recent overview of academic research, see Friede, G., Busch, T., & Bassen, A. (2015) *ESG and financial performance: aggregated evidence from more than 2000 empirical studies*, Journal of Sustainable Finance & Investment, 5:4, 210-233

Sustainable investment and long-term investing

In recent years, a number of leading institutional investors have been actively promoting the concept of 'Long-term' investing – an approach which can also serve as a firmer foundation for more mainstream sustainable investment strategies. McKinsey and the Canadian Pension Plan Investment Board have been key proponents; in 2013 they established the "Focusing Capital on the Long Term" (FCLT) initiative to help overcome the financial market's focus on short term performance.

The FCLT arose from a recognition that many asset managers do not adequately address the obligations of larger institutional investors' to manage longer-term risks and invest in those companies best positioned for long-term success. The FCLT has recommended that investors should give more concrete and clearer incentives to orient their strategies around long-term drivers of success. This should, in turn, incentivize companies to give a clearer articulation of their long-term strategies in public reporting.

In 2015, the FCLT published the "Long-term portfolio guide". This document provides a series of recommendations to asset owners for developing more long-term investment strategies, including the use of longer term incentives for asset managers and the development of alternative benchmarks to market cap weighted indices.[4]

The FCLT's framework also serves as a useful basis for developing an approach to sustainable investment – one that better enables mainstream managers to serve institutional clients. Sustainability issues - from climate change, to increasing inequality, to energy efficiency - impact company performance and risk over a longer-term time frame. Strategies which explicitly integrate these issues are particularly appropriate for institutional investors, given their similarly long-term investment horizon. Understanding sustainable investment in terms of long-term investing can offer a framework within which strategies and approaches can be developed that are consistent with the longer-term fiduciary obligations that institutional investors have.

As well as providing a clearer basis for understanding sustainable investment, the concept of long-term investing has implications for how mainstream asset managers can integrate sustainability into their strategies. Specifically, we believe the following approaches can offer larger asset managers a higher likelihood of attracting larger sums of capital to sustainable investment solutions:

Focus on tailored solutions rather than products
This is probably the most important aspect in order to appeal to the diverse needs of various asset owners. Asset managers should adopt a flexible approach, allowing them to meet their clients' combined financial and sustainability objectives. Today a broad range of sustainability information is available in the marketplace, and this data can be integrated with financial strategies in a variety of ways. For sustainability to transition from niche to mainstream, it is important that mainstream asset managers adopt a solutions-oriented approach to meet the diverse needs of their clients.

Changing the question of financial performance and sustainability to a commitment
In establishing customized approaches for clients, it is incumbent upon asset managers to ensure that sustainability mandates are built on a commitment to meet their clients' primary underlying financial objectives. In the past, sustainable investment may have been sidelined by concerns about a negative impact on financial performance. This ignores an important consensus of academic research which finds that integrating sustainability information does not harm performance and can help to mitigate risks. Mainstream asset managers should therefore use the breadth of financial resources available to them to give their clients' confidence that their financial objectives, and consequently their fiduciary obligations, will be met when developing sustainable investment strategies.

4 "Long-Term Portfolio Guide," www.fcltglobal.org/tools/resources/article/investing-for-the-future-a-long-term-portfolio-guide

Integration of sustainability into financial analysis

In order to move beyond the limitations of sustainability screening discussed above, mainstream asset managers should ensure that material sustainability factors are integrated into the financial research which underlies their actively managed strategies. By explicitly integrating sustainability analysis into buy-side recommendations, mainstream asset managers can ensure that strategies take better account of the long-term risks, opportunities and competitive advantages of companies. This is critical in order for managers to demonstrate to asset owners that they are taking a long-term approach to their investment strategies and to differentiate from the market's short-term focus.

Develop strategies that focus on long-term opportunities of companies' products and services

Although ESG screening and research has provided a strong foundation for assessing the internal risk management governance of companies, it has been less successful in addressing the long-term growth of companies through their products, services and business strategies.[5] By giving more explicit consideration to the impacts and opportunities created by long-term sustainability trends – climate change, energy efficiency, growing inequality and an aging population – mainstream asset managers have the chance to develop strategies that will appeal to those investors with an orientation toward longer-term performance.[6]

Pursuing collaborative engagements with companies focused on material improvements

Perhaps the most important role asset managers can play in mainstreaming sustainability is to engage with companies in which they are invested to make improvements over time. While engagement within sustainable investment has often been pursued from an ethical perspective, mainstream asset managers have an opportunity to ensure that a) engagement is aligned with the investment process and b) it is strategically organized around sustainability issues that have a material impact on long-term business performance. This would allow asset managers to enhance their investment strategies by generating improvements in their core active holdings, offering long term benefits for shareholders and society as a whole.

5 For more on this point, see "Investment governance and the integration of environmental, social and governance factors", OECD, May, 2017, pp. 40-42.
6 For an overview of recent approaches to the integration of sustainability into financial analysis, see The UN PRI, "A Practical Guide to ESG Integration for Equity Investing," 2016. www.unpri.org/news/pri-launches-esg-integration-guide-for-equity-investors.

The investment case for Sovereign investors

The case for asset managers to integrate sustainability in their offerings ultimately rests on one question: to what extent can clear benefits for clients be identified? We would argue that one institutional client group who are uniquely positioned to see both financial benefits and synergies from a sustainable mandate are the Sovereign investors.

Over the past two decades the assets managed by central banks and SWFs have increased dramatically as result of soaring commodity prices, strong growth in emerging markets and ballooning foreign exchange reserves.

With some notable exceptions – i.e. Norway's NBIM, Singapore's GIC or more recently, the New Zealand Superannuation Fund and China's CIC – Sovereign institutions have lagged pension and insurance funds in integrating sustainability considerations within their investment framework. There are a number of reasons for this.

First of all, the majority of assets managed by central banks and SWFs are largely concentrated in emerging markets. Given their strong focus on rapid income growth, sustainability issues (i.e. pollution and climate change considerations) were not high on their policy agendas until fairly recently. However, this is changing fast. Greater attention is now being paid, not just to the quantity of the growth but to the quality well. The best example is China, which is investing heavily in the green sector with the clear objective of improving its citizens' quality of life. This policy focus is gradually feeding through to those state-controlled entities managing the reserves of the country, which now place a strong emphasis on green and social investing.

Secondly, many such institutions have specific mandates which, in turn, have implications for the ways in which assets are invested. For instance, central banks have a very well defined mandate, i.e. the management of liquidity and exchange rates. Other considerations are less of a priority. SWFs for their part often need to provide funding to their sponsoring governments, as seen in recent years following the drop in oil prices and subsequent impact on the fiscal balances of these countries. In such instances the investment focus has been on capital protection and liquidity management, thereby reducing any appetite for more innovative investment solutions, including the broadening of sustainable investments. But this too is changing. SWF mandates are now increasingly incorporating economic and social impact considerations.

Last, but not least, central banks and SWFs provide varying degrees of transparency across countries and regions. Many of these entities do not disclose detailed information about their holdings, given the potential negative backlash that a closer scrutiny of their operations could have on investment performance. Consequently, they face less political pressure from politicians and other interest groups, particularly when compared to those institutional investors such as pension funds where levels of public scrutiny are far higher. But this will change. There is a growing trend towards transparency across the entire financial service industry and the Sovereign institutional sector is no exception.

Several factors differentiate the goals and objectives of Sovereign investors from those of pension funds or other institutional investors like hedge funds.

First, SWFs (in particular Saving Funds), along with state pension funds, are one of the few investor groups that see long-term investing as an integral part of their mandate. Many of these institutions do not have (explicit) liabilities. Together with a few other institutions like endowment funds, they can be seen as true long-term investors.

While on paper, many entities may think of themselves as long-term investors, the financial crisis of 2007-09 showed that while most investors were selling, SWFs were among the few entities that actually invested. This showed true long-term thinking, while at the same time acting as a stabilizer to the global financial system. In addition, many Sovereign entities, including central banks, have a mandate, either implicit, or explicitly expressed in a charter, to focus on fiduciary duties, preserving and growing the funds entrusted to them for the greater good of their country's citizens and future generations. These objectives inherently lead to a greater scrutiny by sponsors as to how returns are achieved and how sustainable those returns are.

One can therefore argue that the key principles of sustainability are in natural alignment with the objectives of Sovereign investors, offering them not just a source of alpha but also a superior, non-traditional framework, within which to assess the risk/return of their investments in the context of their mandate. This holds particularly true for alternative asset classes, where investment success is correlated with a long-term view and superior post-investment management processes.

The clearest financial case for embracing the concept of sustainability in Sovereign asset management can be made for the oil exporting countries which account for roughly half of all sovereign assets globally. Two important issues face these nations over the coming decades: how can they limit their dependence on what are ultimately depleting and obsolete sources of energy, and how can they diversify their revenue sources? While it is rational for these countries to recover as many resources as possible from the ground for as long as demand remains solid or even growing, there is a fundamental challenge that will determine the prosperity of these nations in the future. How do they invest and grow these assets in a way that not only offers a long-term storage of value but which also will not be negatively affected by the unavoidable decline in fossil fuel demand further down the road? Here, the concept of sustainability matches that of sound, long-term risk management, namely: ensuring national wealth is invested on solid pillars for the long-term, and that it is diversified across investment strategies which have a sound basis when it comes to economic, social, environmental and governance factors.

There is one further key factor pertaining to Sovereign investments that needs to be considered: the public nature of their investments and also the way these holdings are managed, developed and governed. The fact that Sovereign entities will play, and are already playing, a crucial role as public promoters of sustainability concepts, could significantly increase their demand for tailored sustainable investment solutions.

Take, for example, the voting behaviors in areas like corporate governance and compensation which are exhibited by a number of Sovereign entities. These act as an often-copied model for other investors, with Norway's NBIM being a prime example. They frequently voice their opinion about contentious corporate governance issues, including executive compensation models, and this will often start broader public discussions. NBIM also frequently and publicly divests from companies that show shortcomings, for example in the area of governance or environmental regulation. Furthermore, the often strong link between Sovereign wealth entities and governments can lead to close contact with standard setters, regulators and academia, fostering discussions around local risk management as well as ESG related regulation. Finally, Sovereign wealth entities are crucial drivers when it comes to the development of local financial markets, especially in emerging economies.

An additional driver behind the increasing focus of SWFs on sustainable investing, particularly that related to the concept of long-term value creation, is the evolving nature of their mandates. SWFs' investment behavior has traditionally been oriented towards return maximization and/or capital preservation. This is gradually changing as a result of the changed global economic climate. SWFs are increasingly required to play an important role in boosting domestic investments and thus supporting economic growth. Many of the more recently established SWFs, for instance in Ireland, Turkey and Kenya, have the mandate to boost investments in domestic infrastructure and attract foreign capital in their economies. This shift from return maximizers to impact maximizers is very much in line with the concept of long-term investing which, as we have seen, is the basis of the current trend in sustainable investments.

While sustainability should not be confused with the more traditional, narrower, focus on socially responsible investments (SRI), it also offers a framework within which to integrate evolving objectives of governments, where key sponsors are often at least as much concerned about reputational issues and headline risk as they are about investment returns. This is particularly true in advanced economies but is also increasingly apparent in emerging markets. With the key principles behind sustainability exerting a greater influence, both on politics and ultimately, on what can be considered good governance at a national level, pressure from sponsors to act as responsible investment entities is expected to increase in the future.

This is particularly true for central banks. While these can be considered to be more short-term oriented Sovereign investors than SWFs, with a higher liquidity preference due to the nature and objective of their foreign exchange reserve management, they are often placed under public and political scrutiny. Here, sustainability offers a sensible approach, one that provides an analytical framework to identify financial value and generate higher risk-adjusted returns while at the same time taking environmental and social factors into consideration, and thus addressing the concerns of key sponsors.

When it comes to the practical implementation, there is one relatively new asset class which could be highly attractive to fixed-income oriented central banks: green bonds. These instruments combine favorable financial conditions due to their often tax-exempt status, with a sustainable approach to the development of brownfield sites. They do this by focusing, in particular, on topics like energy efficiency, pollution prevention, sustainable water management and agriculture, as well as the promotion of new green technologies.

The issuance of green bonds is growing fast with Sovereign institutions leading the way. Poland sold the first ever Sovereign bond in December last year, followed by France a few months later with a EUR 7bn issuance. The French Sovereign green bond issue was heavily subscribed with demand exceeding EUR 23bn. More governments, including many emerging markets, are set to follow this year. There is an expectation that such significant recent issuance activity from certain Sovereigns, and the attention this has received from investors and rating agencies, will increasingly solve the sector's remaining challenges, notably: concerns around liquidity, a lack of available research and (rating) coverage, and as yet unclear standardizations for issuers and benchmarks for investors. With these issues expected to be addressed soon, green bonds could be a highly attractive addition to Sovereign portfolios.

In conclusion, the concept of sustainability is one which is ideally placed to align the long-term mandate of Sovereign wealth entities with trends in society, as well as the evolving objectives of government sponsors and the public in general. In particular, in a world that is moving away from fossil fuels, sustainability can be considered a key tool in re-focusing the assets of Sovereign investors in a way that is consistent with long-term financial and social objectives of their nations.

UBS AM Sustainable and Impact Investment Strategy

UBS Asset Management has extensive experience in sustainable investing and has managed Sustainable funds for well over two decades. We have increased our focus on sustainable investing solutions in response to growing demand from institutional clients. UBS Group recently committed to 'mainstreaming' sustainability by integrating ESG considerations into core investment processes throughout the firm.[7] In UBS Asset Management, we are working on integrating sustainability considerations into the research used in our active investment strategies and dedicating resources to providing customized sustainable investment solutions.

UBS Asset Management has increasingly focused on partnering with institutional clients to meet both their sustainability and financial goals. Below are two recent examples of collaborations that have led to innovative sustainable investment solutions.

The Climate Aware Strategy.

A UK pension fund faced the challenge of managing climate change risks in the passive portion of its equity portfolios. The fund needed to account for climate risks in its passive strategies while maintaining relatively strict limits on tracking error to the FTSE All Share Index benchmark. An important factor was not only to limit exposure to current CO_2 emissions but also to manage future risks in order to ensure that the portfolio was aligned with the Paris climate summit's 2 degree scenario and carbon reduction targets.

By combining environmental data from several sources, UBS Asset Management developed a portfolio optimization model which reduces exposure to climate risk while simultaneously maintaining the client's restrictions on tracking error. Rather than simply reducing exposure to companies with higher CO_2 emissions, UBS AM's team examined the trajectory of emissions reduction over time, as well as company management commitment to emissions reduction, to orient the portfolio toward companies that are better prepared for a low carbon future and the 2 degree reduction scenario. Moreover, the strategy reduces the exposure to, rather than excluding, companies with higher carbon risk in order to pursue strategic engagement with these companies. UBS AM's engagement team explains the climate risks that have been identified from the research and provides concrete suggestions to these higher risk companies in order that they can learn and make improvements in their performance over time.

7 See UBS 2016 Annual Review, p. 5. www.ubs.com/global/en/about_ubs/about_us/annual-review-2016.html

Impact measurement for public equities.

A large Dutch pension fund needed to develop better disclosure to its beneficiaries on the social and environmental impacts of a portion of its global equity portfolio. Recognizing that such metrics go beyond ESG data provided by traditional sustainability research providers, the client needed an asset manager capable of measuring the external environmental and social impact of companies' products and services. At the same time, they required an asset manager with global research and portfolio management capabilities that could deliver competitive active returns on its diverse portfolio of companies.

UBS Asset Management was able to meet the client's objectives by establishing a research partnership with Harvard University's School of Public Health and the City University in New York to develop a proprietary set of impact measurement metrics. UBS AM is leveraging the research of its global network of financial analysts to deliver strong financial performance while engaging with the companies directly to obtain greater insight into impact measurement. The metrics developed as part of the mandate are the first of their kind and can help provide a basis for other institutional investors to apply impact investment principles to various areas of their actively managed portfolios.

Both of these recent collaborations point to the importance of working directly with larger institutional investors to meet their combined financial and sustainability objectives. They also demonstrate how such collaborations can serve as an important basis for innovation. Innovative partnerships such as these will be essential in driving the assets of larger institutional investors into sustainable investment strategies over the next few years.

To learn more about Sustainable investing at UBS Asset Management please contact:

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Whatever your investment profile or time horizon, we work with you to design a tailored sustainable solution to meet your objectives

Sustainable and impact investing approach

Exclusion
Screen and exclude companies or sectors that do not meet certain social, environmental or ethical criteria

Integration
Combine ESG factors with traditional finance considerations to make investment decisions

Positive screening based on ESG ratings: Focus on securities with strong ESG characteristics in combination with attractive financial fundamentals

ESG integration: incorporates ESG risks and growth opportunities into traditional security valuation and research process

Impact investing
Explicit intention to generate a measurable social and environmental impact alongside a financial return

Additional dimensions

ESG research integration
Sustainability considerations are integrated in UBS AM research process across asset classes

Proxy voting and actve engagement

ESG measurement and reporting

→

Traditional UBS offering

Sustainable and impact investing offering

Your global investment challenges answered

Drawing on the breadth and depth of our capabilities and our global reach, we turn challenges into opportunities. Together with you, we find the solution that you need.

At UBS Asset Management we take a connected approach.

Ideas and investment excellence
Our teams have distinct viewpoints and philosophies but they all share one goal: to provide you with access to the best ideas and superior investment performance.

Across markets
Our geographic reach means we can connect the parts of the investment world most relevant for you. That's what makes us different – we're on the ground locally with you and truly global.

A holistic perspective
The depth of our expertise and breadth of our capabilities allow us to have more insightful conversations and an active debate, all to help you make informed decisions.

Solutions-based thinking
We focus on finding the answers you need – and this defines the way we think. We draw on the best of our capabilities and insights to deliver a solution that's right for you.

What we offer
We offer a comprehensive range of active and passive investment styles and capabilities, across both traditional and alternative asset classes. Our invested assets total CHF 697 billion[1] and we have over 3,600[2] employees in 22 countries.

Who we are
Backed by the strength of UBS, we are a leading fund house in Europe, the largest mutual fund manager in Switzerland and one of the largest fund of hedge funds and real estate managers in the world.

[1] Data as of 31 March 2017
[2] Thereof around 1,200 from Corporate Center. Data as of 31 December 2016

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