Sustainability focus:

A lasting impact

The sustainability imperative

UBS Asset Management explores potential strategies to address critical challenges in a changing world

Highlights
- Institutional investors face growing pressure to invest sustainably – and to measure the positive environmental and social impacts of their portfolio.
- Investors must meet increasingly complex sustainability goals in a low-return environment, which have left many pension funds below actuarial funding targets.
- Developing the right approach to new sustainability goals requires asset management expertise beyond fundamental investing – including scientific research, data collection and management.

The use of ESG factors – environmental, social and governance – in investment strategies has accelerated in recent years as investors have come to understand the value of non-financial material data to risk management and performance. Especially as ESG reporting has become more widespread, investors have come to view this data as an important contributor to investment decision making.

At the same time, many pension funds are currently underfunded and are also struggling to meet actuarial funding targets in the current low-yield environment. Currently, investors representing $62 trillion in assets under management have signed up to the UN-backed Principles for Responsible Investment, promising to support environmental goals such as carbon reduction. The Climate Risk Task Force of the Financial Sustainability Board recently published a set of recommendations for investors, lenders and insurance underwriters for better disclosure and understanding of material risks. We believe that these recommendations will increase awareness by all stakeholders and also accelerate ESG integration.

In the past few years investors increasingly are being asked to not only consider the sustainability practices of the companies they invest in – the original focus of ESG strategies – but to also show in a measureable way the external impact of their investments on the global environment and society. In order to help our clients fulfil this commitment, UBS Asset Management has drawn on its unique sustainable investment expertise and partnered with experts from our investment teams and across academia to help develop new measurement frameworks.

Our proprietary approach to managing data

UBS Asset Management has a long history of developing proprietary methodologies that incorporate sustainability factors into fundamental research, analysis and investment decision-making. We were early in grasping the material relevance of sustainability data to valuation analysis, and spent more than a decade developing a proprietary database and scoring methodology to integrate environmental, social and governance factors in our investment processes. At the heart of this effort is the belief that only we can decide which factors and inputs are material. This is no different from our sole reliance on internal UBS Asset Management cashflow estimates. While there are commercially available standardised ESG databases, just as there are external cashflow estimates, we wanted to ensure that we selected data we believed to be material and that we could test, correct and update internally as data evolved. This process allowed us to create an objective ESG score that is transparent, comparable, and reflects our proprietary assessment of each company's sustainable profile.

We continue to reap the benefits of being an early mover with respect to leveraging an internal database to evaluate the sustainability of our portfolio holdings. UBS Asset Management is now leveraging and further adapting this methodology to integrate ESG factors across other asset classes.

A forward-looking approach to carbon awareness

This extensive background in ESG research and data collection provided a good background to respond when a large UK government-sponsored pension fund asked UBS Asset Management to develop a passive carbon-aware product that aims to replicate benchmark returns while increasing relative exposure to companies that are adapting to a lower-carbon future.

To meet this client's needs, we developed a proprietary framework to create a composite score for companies based on current and historical carbon data (including data uncertainties), probable carbon reduction path and forward-looking variables that gauge a company's commitment to and engagement with emission reduction initiatives.

It takes into account the 'carbon glide path' required of each of the selected index's industry sectors and companies that either need to reduce carbon intensity or are carbon neutral, such as renewable energy.

UBS Asset Management's approach differs from the standard investment community approach of overweighting stocks of companies that are less dependent on fossil fuel, based primarily on historical or current carbon data. We believe that this approach misses the forward-looking aspirations of the global community under the Paris Accord, to increase the probability by 50 per cent that the global temperature increase will stay at/below the 'safe' level of two degrees centigrade at the end of this century.

According to the estimates of the International Energy Agency (IEA), this requires an 80 per cent reduction in carbon emissions by 2050.

As of 30 June 2017 this client has approximately $229 million in assets under management in this strategy. This approach can also be extended to active systematic portfolios.

ESG's toughest challenge: Measuring the impact of a portfolio

The newest and most cutting edge development in institutional sustainable investing is the search for ways to make a measurable impact on global environmental challenges within equity and fixed income portfolios without sacrificing financial returns.

In a 2016 investor survey conducted by the Global Impact Investing Network, 100 per cent said they wanted to better understand the social/environmental impact performance of their investments (see exhibit 1).

Institutional impact investments accounted for less than $250 billion at the end of 2015, but impact investing has become one of the fastest growing.

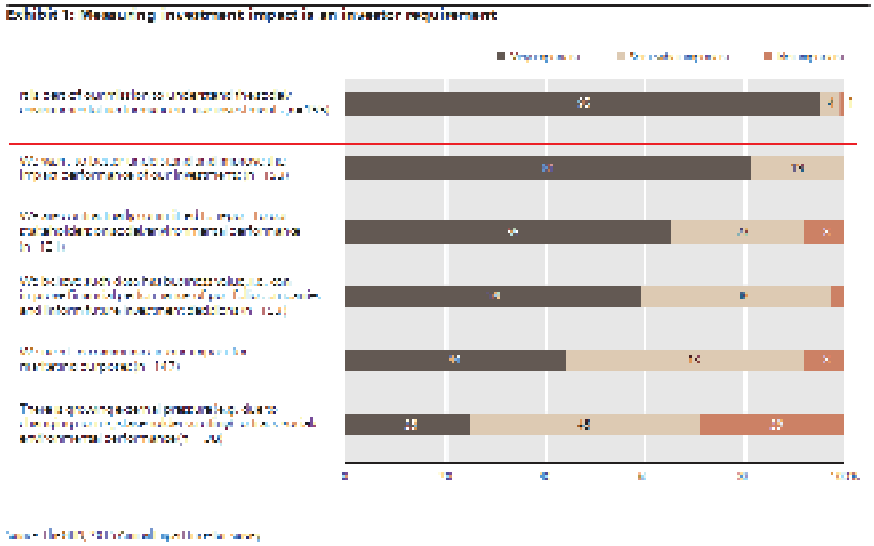
We have seen a marked increase in interest from our mainstream clientele, particularly institutional asset owners.

Developing a consistent and accurate framework for measuring the impact of an investment portfolio is the next evolution of sustainable investing in our opinion.

Conclusion: A legacy of pioneering sustainability research

As institutional investors take the next logical step and seek to measure their impact on critical global environmental and social challenges, UBS Asset Management's legacy of ESG research and data development forms a solid foundation for developing a new type of framework to measure results.

Exhibit 1: Measuring investment impact is an investor requirement



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Summary
• The general consensus amongst several commentators is that there is now a growing appetite for sustainable investment in pension funds around the world.
• Although academic evidence clearly indicates no impact on returns, concerns remain regarding the impact of sustainable investing on investment performance.
• Some observers anticipate that ETFs and green bonds will continue to be important investment vehicles for sustainable investing.

Andrew Williams considers the role institutional pension fund managers have to play within sustainable investing

As awareness of environmental, social and ethical issues increases, pension fund managers around the world are facing growing investor pressure to improve their record on making sustainable investments. So, are institutional pension fund managers currently meeting investors' needs and wishes to invest their money in a sustainable manner? What improvements have been implemented recently? And how best can institutional pension fund managers with responsibility for DB and DC schemes implement sustainability considerations in their approach?

Growing appetite

Broadly speaking, Aberdeen Standard Investments' responsible investment analyst Andrew Mason believes that institutional investor needs for sustainable investment are currently being met. That said, he points out that there is still a "sliding scale of maturity" ranging from highly-active strategies to more compliance-based approaches among fund managers.

"This is also the case with investors. Approaches and levels of maturity can be loosely ascribed to geographies, with Northern Europe and Scandinavia talking the lead in numerous areas," he says.

Elsewhere, UBS head of sustainable investment research, Christopher Greenwald, highlights the fact that some of the leading European pension funds are currently doing a lot with regard to sustainable investing (SI), particularly in Holland and the Nordic region. Even so, he reveals that results in the rest of the continent are mixed but improving. For those pension funds that may be just starting to implement a responsible investment policy, Greenwald also points out that there remains a concern regarding the impact on investment performance – which he warns can hinder widespread adoption of SI strategies.

"While academic evidence clearly indicates no impact on returns, the primary challenge thus far has been that most SI products have been provided by smaller, SRI asset managers, which often do not have the resources or track record to convince pension funds to pursue SI strategies," he says.

"This is now starting to change as larger asset managers such as UBS invest strategically in sustainability across asset classes," he adds.

Principles for Responsible Investment's (PRI) managing director Fiona Reynolds agrees there is "no doubt" that the appetite for sustainable funds is growing rapidly. She says that according to the Global Sustainable Investment Alliance, over $22 trillion of assets were managed under responsible investment strategies globally in 2016, up 25 per cent from two years before. She also believes that the growth of new technologies and the move to renewable energy sources is helping to drive demand.

"Investors can take advantage of a number of options across asset classes – public and private equity, fixed income and alternative assets. In recent years, there has been a proliferation of new ESG-focused investment strategies and vehicles. These include index and smart-beta funds and quant strategies, to name a few," she says.

For Reynolds, this increased activity means that managers must do more in the coming years to meet increasing demand from clients for sustainable investments.

"Research from Morgan Stanley

found this will present both opportunities and challenges for managers, including capacity issues, for example, the ability of smaller firms to handle capital inflows and a demand for knowledgeable staff to develop these new products," she says.

Meanwhile, Legal & General Investment Management head of institutional distribution Mike Walsh believes there has been a significant improvement in this area recently, particularly as investors begin to fully appreciate the financial implications and benefit of taking sustainability into account when making investment decisions. In Walsh's view, companies that demonstrate good corporate governance and have sustainable business models will usually generate superior financial benefits for their shareholders.

"The ultimate goal of environmental, social and governance monitoring is to ensure company management align their business objectives with the long-term interests of investors. By doing this, we aim to protect our clients' assets from corporate failure and deliver benefit from long-term sustainable asset growth," he says.

"LGIM believes that companies that demonstrate good corporate governance and have policies for a sustainable business model will deliver enhanced long-term investor value," he adds.

Recent improvements

For Mason, one of the key recent improvements is greater demand from asset owners on their fund managers and an appreciation that considering financially material sustainable issues is part of fiduciary duty. He also points out that one of the most recent innovations is the development of impact funds that seek to invest in companies with positive social and environmental impacts without sacrificing financial returns.

"I think there will be further innovation in the types of bonds that are brought to market, building upon the rapid growth of green bonds. I also think there will be more scrutiny of fund performance in relation to sustainable impacts, not just financial performance," he says.

In considering some of the most interesting and innovative recent examples of sustainable investment practice, Greenwald reveals that a lot of interest and work currently surrounds the United Nations' (UN) sustainable development goals, which he believes demonstrates the positive impact of sustainable investment on the environment and society.

"UBS has partnered with a leading Dutch institutional investor – as well as some of the leading academic institutions – to develop a new set of impact metrics to report on the environmental and social impact of investment holdings for the first time," he says.

"We believe that this will help investors better understand the environmental and social impacts of their investment strategies," he adds.

In terms of recent innovations, Reynolds also reiterates that fund managers are looking to expand their ranges of sustainable products – and reports that ETFs and green bonds will continue to be important vehicles for sustainable investing as investors look more closely at fixed income opportunities.

"New regulatory pressures are also expected to keep driving the momentum of sustainable investments. Another critical driver, which will continue shaping the sustainable investment landscape, is the growth of millennials, who stand to inherit $59 trillion by 2060. This generation doesn't just want to make money, they also want their investments to be sustainable, and to address issues such as child labour and corporate governance," she says.

Integrating ESG

Commenting on how best institutional pension fund managers with responsibility for DB and DC schemes can implement sustainability considerations in their approach, Mason argues that the first consideration should be what is required for members of the schemes – as well as if there is common ground that should be overlaid, for example the screening out of certain sectors such as tobacco.

"Fund managers should consider what their position is in relation to the integration of sustainability into stock selection and how integration best informs their investment process and performance," he adds.

Greenwald believes that employees need to be given the baseline confidence that their pension fund investors will attain competitive financial returns, and stresses the importance of ensuring that sustainability options are presented as an option with a commitment to deliver competitive returns.

"With a DB or DC scheme that invests in a variety of options and asset classes with leading asset managers, this is possible to provide. Our experience with private clients within UBS Wealth Management is informative: when clients are given the commitment that they will deliver competitive returns and are given the option to choose sustainable investment products, the demand for SI is extremely strong," he says.

"Similarly, SI pension schemes should be presented not simply as an option but as an option that will deliver competitive returns in order to tap into the demand and interest that particularly millennials have in sustainable investing," he adds.

Finally, Reynolds stresses that institutional investors must be able to analyse the sustainability-related performance, risks and impact of their investments, and communicate them to their stakeholders.

"It's not enough for a DC scheme to offer an SRI option. They should integrate ESG issues across all the funds offered, with a particular focus on the default fund. The Pensions Regulator has been very clear on this point," she adds.

Written by Andrew Williams, a freelance journalist

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