

# Adding value(s) to investing

**Sustainable investing**

March 2015



## Publication details

### Publisher

UBS Financial Services Inc.  
1285 Avenue of the Americas  
New York, NY 10019

This report has been prepared by UBS Financial Services Inc. ("UBS FS") and UBS AG. Please see important disclaimer and disclosures at the end of the document.

This report was published on 24 March 2015.

### Editor-in-chief and lead author

Stephen Freedman

### Contributing authors *(in alphabetical order)*

Nils Beitlich  
Carl Berrisford  
Cyril DeMaria  
Christophe de Montrichard  
Andrew Lee  
James Purcell  
Alexander Stiehler  
Thomas Veraguth

### Desktop Publishing

George Stilabower  
Cognizant Group – Basavaraj Gudihal,  
Srinivas Addugula and Virender Negi

### Project Management

Paul Leeming

# Contents

## Adding value(s) to investing

---

### 02 Editorial

---

### 04 Introduction: Adding value(s) to investing

---

### 06 Chapter 1: Sustainability: Why now?

Changing attitudes in society underpin sustainable investing

---

### 14 Chapter 2: Sustainable investing approaches

Building blocks of a sustainable investing framework

---

### 19 Chapter 3: Executing your sustainable investing strategy

Questions to consider prior to implementing

---

### 27 Outlook and conclusions

---

### 28 Appendix

---

Don't judge each  
day by the harvest  
you reap, but by the  
seeds you plant.

**Robert Louis Stevenson** (1850–1894), writer



Bob McCann



Jürg Zeltner



Mark Haefele



Caroline Anstey

# Dear readers,

Sustainable investing is a force to be reckoned with. UBS's stakeholders - clients, employees, investors, government agencies, and civil society - are concerned about the broader impact of business activity and the investment community's response. These changing expectations are affecting how companies operate. Many are already managing relevant risks and seizing related opportunities. Investors are also increasingly incorporating environmental, social, and governance factors into their decisions.

This report covers the why, what, and how of this field. First, it highlights reasons and motivations to get involved. It then presents three building blocks for a sustainable investing strategy. Finally, it considers how to implement them in portfolios.

UBS is committed to running businesses, supporting employees, and helping clients operate according to sustainable and responsible principles. We have accomplished a great deal in this area with respect to our practices, risk policies, and corporate social responsibility programs. However, we are now taking

steps to embed this approach more broadly within our DNA. Our global goal is to develop a comprehensive, industry-leading platform of research, advice, and products that is dedicated to sustainable investing and philanthropy.

UBS believes sustainable investing is here to stay, and we will continue to work to fulfill clients' needs in this area, now and in the years to come.

Sincerely,



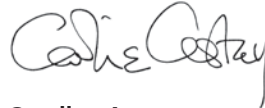
**Bob McCann**  
CEO, UBS Group Americas



**Jürg Zeltner**  
CEO, UBS Wealth Management



**Mark Haefele**  
Global CIO, UBS Wealth  
Management



**Caroline Anstey**  
Global Head UBS and Society

# Adding value(s) to investing

In recent years, growing portions of society have raised concerns about the prevailing economic growth model. The visible impact of human activities on the natural environment, resource scarcity in an expanding global economy, greater awareness of the waste inherent in many traditional business models and of the limitation of various corporate governance practices have driven a broad change in mindset. At the same time, we are seeing a growing realization that companies can be at the heart of solutions to many of the world's social problems.

Recently, The Millennium Project – a global research think tank – identified 15 global challenges, a clear majority of which are directly related to sustainability concerns (see Fig. 1).

The investment community has also recognized these issues, and a sustainable investing (SI) industry has emerged, which is now shifting from the fringes to the mainstream of the financial landscape.

This introduction to SI is targeted at investors new to the field as well as those with some familiarity who wish to learn more.

**Fig. 1: The 15 global challenges facing humanity according to The Millennium Project**

Sustainable development and climate change	Education
Clean water	Peace and conflict
Population and resources	Status of women
Democratization	Transnational organized crime
Global foresight and decision making	Energy
Global convergence of IT	Science and technology
Rich–poor gap	Global ethics
Health issues	

Source: The Millennium Project, 2014.

Note: The Millennium Project was initiated by the Smithsonian Institution, the Futures Group International and the United Nations University in 1996.



The United Nations' Brundtland Commission<sup>1</sup> provided the landmark definition almost 30 years ago that still best captures the essence of sustainability.

Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.



# Sustainability: Why now?

Changing attitudes in society underpin sustainable investing

The human race is challenged more than ever before to demonstrate our mastery, not over nature but of ourselves.

Rachel Carson (1907–1964), conservationist





Sustainable investing (SI) is growing faster than the financial industry at large. The key driver is society's changing attitudes regarding sustainability questions. In particular, various stakeholder circles within society have evolved in their expectations regarding the appropriate role and behavior of corporations in recent years. The attitudes of consumers, employees, investors and civil society at large are changing perceptibly. These stakeholders are placing more stringent demands on companies (see Fig. 2).

In a 2014 survey of 30,000 respondents across 60 countries, Nielsen, a consumer research firm, found that:

- 55% of respondents are willing to pay extra for products and services from companies that are committed to positive social and environmental impact, up from 45% in 2011 (see Fig. 3 on pg. 13).
- 52% of respondents reported having purchased at least one product or service from a socially responsible company during the last six months.
- 67% would prefer to work for a socially responsible company.

The rising influence of the Millennial generation – those born between the early 1980s and early 2000s – and their idealism is an important driver behind this shift in societal expectations. Even though Millennials still do not control a significant share of investable assets, their impact is being felt through how they are shaping demands on companies from different stakeholder groups.

## UBS CIO definition of sustainable investing (SI)

We define SI as a set of investment strategies (exclusion; integration; impact investing) that incorporate material environmental, social and governance (ESG) considerations into investment decisions. SI strategies usually seek to reach one or several of the following objectives: 1) achieve a positive environmental or social impact alongside financial returns; 2) align investments with personal values; and 3) improve portfolio risk/return characteristics.

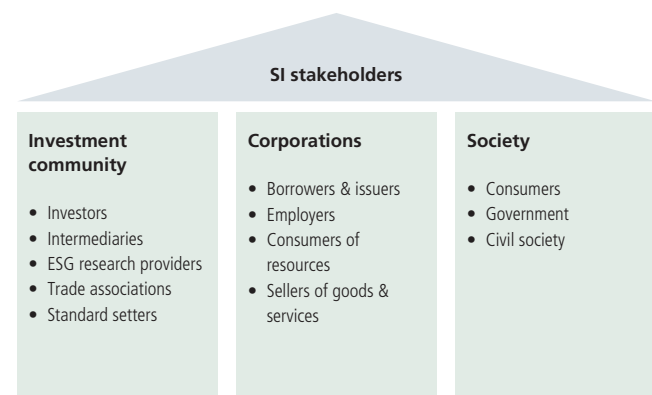
In many countries, the result of these shifting expectations is or is likely to be government involvement either through law-making or regulation. At that point, societal demands become binding on companies. The key is that whether through stakeholder demands or government rules, these trends are affecting the operating environment for companies, who now ignore such considerations at their own risk.

## Evidence gathered in listed markets over the last few decades shows no significant performance difference with conventional approaches.

### Investors catching on

The SI movement has gathered steam as a result of evolving investor demand. Growth in the number of financial firms that have signed on to the UN Principles for Responsible Investment (PRI), as shown in Fig. 4 (pg. 13), offers evidence of the adoption rate. The Principles are a set of six voluntary, aspirational commitments to incorporate environmental, social, and governance (ESG) factors into an institution's investment decision making and ownership practices. Members report publicly on their own progress, thereby promoting more widespread adoption and implementation of the Principles. The PRI stands at the focal point of an international network of investors established to help members put the Principles into practice through shared resources.

**Fig. 2: Multiple stakeholders influence the sustainable investing (SI) landscape**



Source: UBS

### Corporations rising to the challenge

Corporate leaders also recognize the challenges that lie ahead. To satisfy growing investor demands, corporations are engaging with the investment community on related issues. In particular, transparency and corporate responsibility (CR) reporting are on the rise. The audit firm KPMG found in a 2013 survey that CR reporting is undertaken by almost three-quarters (71%) of the 4,100 companies surveyed worldwide, an increase of seven percentage points since 2011.

In addition, a 2013 UN Global Compact–Accenture survey of 1,000 CEOs across 103 countries found that 93% believe that sustainability will be important to the future success of their

business. This highlights the growing recognition that it is not only a risk consideration for companies but also a competitive differentiator. At the same time, only 32% of the respondents believe that the global economy is on track to meet the demands of a growing population within environmental and resource constraints.

The result of these parallel trends: SI has come a long way and can now be considered an established subsector of the investment industry. It has evolved from modest origins anchored in a faith-based perspective with an emphasis on avoiding undesirable investments in the first half of the last century, to a more disciplined approach that has now reached a level of maturity, organization and broad acceptance (see timeline on pg. 12).

## SI around the globe

In the US, interest in SI has traditionally been driven by institutional investors such as pension funds. More recently, the trend has started to catch on with university endowments. Harvard University's endowment signed the UN PRI initiative last year and is now one of 1,353 signatories worldwide (see Fig. 5 on pg. 13). Stanford University announced in May 2014 that its endowment was divesting from coal companies. The trend is gradually spreading to individual investors as well. In particular, younger individuals from the Millennial generation, who are beginning to enter the investment community, have consistently placed a greater emphasis on SI than their parents and grandparents did, thereby catalyzing the change in attitudes.

In Europe, institutional investors have played a key role in the spread of SI as well. In addition, governments are facilitating adoption through regulation. At least eight countries have related national regulations that directly impact their pension systems: United Kingdom, France, Germany, Sweden, Belgium, Norway, Austria, and Italy.

In Asia, the approach has gained traction in recent years. According to the Asia Sustainable Investment Review, SI assets in Asia ex-Japan stood at USD 45bn, growing at a 22% annualized rate (2011–2013). A further strong government policy impetus can be expected on the back of the March 2015 Chinese anti-pollution documentary *Under the Dome* which has graphically highlighted China's environmental plight. Several Asian governments including China and Indonesia have recently introduced significant green financing initiatives.

### What drives investors to SI?

Investors are usually drawn to sustainable investing by one, and often a combination of, these three motivations:

1. A belief that portfolio risk/return characteristics can be improved by factoring sustainability into investment decisions
2. A willingness to exert a positive impact on society and the environment through their investments
3. A desire to align their financial portfolio with their personal values

*1) Improved expected portfolio risk and/or return:* The rationale behind this motivation is that the wealth of sustainability-related information available is not fully considered by the mainstream investment community when selecting investments, due either to a lack of familiarity or a tendency to focus on short-term value drivers. Integrating such factors into security selection along with traditional financial factors can be considered a means to better identify growth opportunities or business and reputational risks relevant for companies.

*2) Positive impact:* Exerting a positive social and/or environmental impact through investments is gaining popularity. One focus can be on actively directing capital to the best companies according to environmental, social and governance criteria. A second focus can be on shareholder engagement to influence corporate decisions, which is sometimes a desired feature of professionally managed funds. The most progressive version of this motivation is achieved through impact investing (see Chapter 2), investments made with the explicit intention to generate a measurable social and environmental impact alongside a financial return.



*3) Values alignment:* This is probably the most traditional motivation for SI. Originating among faith-based investors, its resonance has broadened over time. This motivation is often associated with exclusionary approaches that eliminate companies or industries active in areas deemed incompatible with the investor's value system. The main benefit here is the peace of mind the investor enjoys in knowing that he or she is not financing such activities. The performance motive is not a key driver, though there is usually an expectation that performance will not be negatively affected by the approach.

#### **Unjustified performance concerns**

When considering SI, investors often ask whether such strategies hinder financial performance. Interestingly, evidence gathered in listed markets over the last few decades shows no significant performance difference with conventional

approaches. This can be illustrated by comparing the performance of the stock indexes that incorporate SI principles with that of regular stock indexes (see Fig. 8).

Performance differences can occur in specific markets and time periods, but on balance across markets and through full market cycles, evidence suggests that SI performs no better and no worse than traditional approaches. A UBS CIO survey of academic studies analyzing performance relative to conventional approaches (see Fig. 7) confirms this. Performance should therefore not be expected to differ meaningfully from that of conventional investments.

# Ask the investor

Investors can be driven to sustainable investing for different reasons.

Stephen Freedman spoke with two of them to gain insight into their motivation and perspective.

**John Dodge:** Individual investor; Seattle, WA

**Rick Segal:** Chairman, Seavest Investment Group; and  
Managing Partner, Rethink Education; White Plains, NY

**Stephen Freedman: How did you become involved in sustainable investing? Was there a specific cause that interested you in particular?**

**John Dodge:** Well, my UBS Financial Advisor came to me about 10 years ago to discuss sustainable investing and I was immediately interested. I felt that I would much prefer having profits come from corporations that made a difference in the world. However, there is a large personal component to my involvement.

On one hand, I am an environmentally sensitive person and I've wanted to have some of my assets invested in alternative sources of energy, whether it be solar or wind power. I wanted to promote that in the United States. Then, from the personal standpoint, I was a civil trial lawyer for 27 years and, in particular, I represented victims of automobile accidents and therefore did not wish to include insurance companies in my investment portfolio. So, I would say it was a general social consciousness combined with my personal experiences that defined my path.

**Rick Segal:** I have been in the private investment world for myself, my extended family and outside clients for over 40 years. I started my career on Wall Street and after about 10 years I had the capital to invest on my own and had developed a network of people with similar values. I came from a family of educators focused on early childhood development and therefore had a heightened awareness of the power of education to mold and shape lives. Those personal values have played a significant role from the beginning.

We've built our business with the overarching philosophy that if we aren't doing something to change, improve or participate in areas that are vital to universal concerns, then we are

not making sustainable investments. Investments that do not qualify in that regard are at the risk of being either faddish or irrelevant. In terms of a specific cause, we have always viewed sectors of the economy like healthcare and education as areas that are important to us. In fact, we launched a venture fund, Rethink Education, focused exclusively on early-stage education technology investments. In these areas, if we are innovative and intelligent with our approaches, we can help facilitate change to systems that address essential human needs.

**When making investments, how do you weigh the importance of financial returns against achieving a positive social impact?**

**John:** Well, for one I have never felt that I was giving up something by investing in a socially responsible manner. My financial advisor simply finds corporations that are performing well, but in line with the idea of investing in a socially responsible manner, these companies are also making a difference. I have done very well in my retirement; in fact I have actually earned more money in my first year of retirement through dividends and capital gains than I did in 27 years as a trial lawyer. And then, it's like the icing on the cake that this is all coming in a socially conscious manner. My money is going towards benevolent corporations instead and turning just as good of a profit at the same time. So to answer your question, I do not think I have had to weigh the options too much. It has not been a trade-off and I feel that I am able to simultaneously achieve investment returns and generate a positive social impact.

**Rick:** I think that investors who believe that the economics of a business investment are a secondary concern are kidding themselves if they believe it will result in a sustainable venture. However, making investments with the economic result being





at least parallel with the impact it will have on society can generate attractive market returns. I do not think there should be a trade-off when searching for financial returns and believe that with our investment process there is no trade-off.

We value both performance and impact. For example, we are not willing to underwrite a company simply because it's doing good things for a number of people. We believe that looks like creative gifting rather than long-term sustainable change. Ultimately, I would say that, analytically, our returns have more than kept up with comparable investments that didn't involve impact. Especially when you are investing in the venture world, I think that provides a tremendous opportunity.

**Rick, can you tell us a little bit more about your experiences with growth capital? Further, how do you make the decision as to what companies to invest in?**

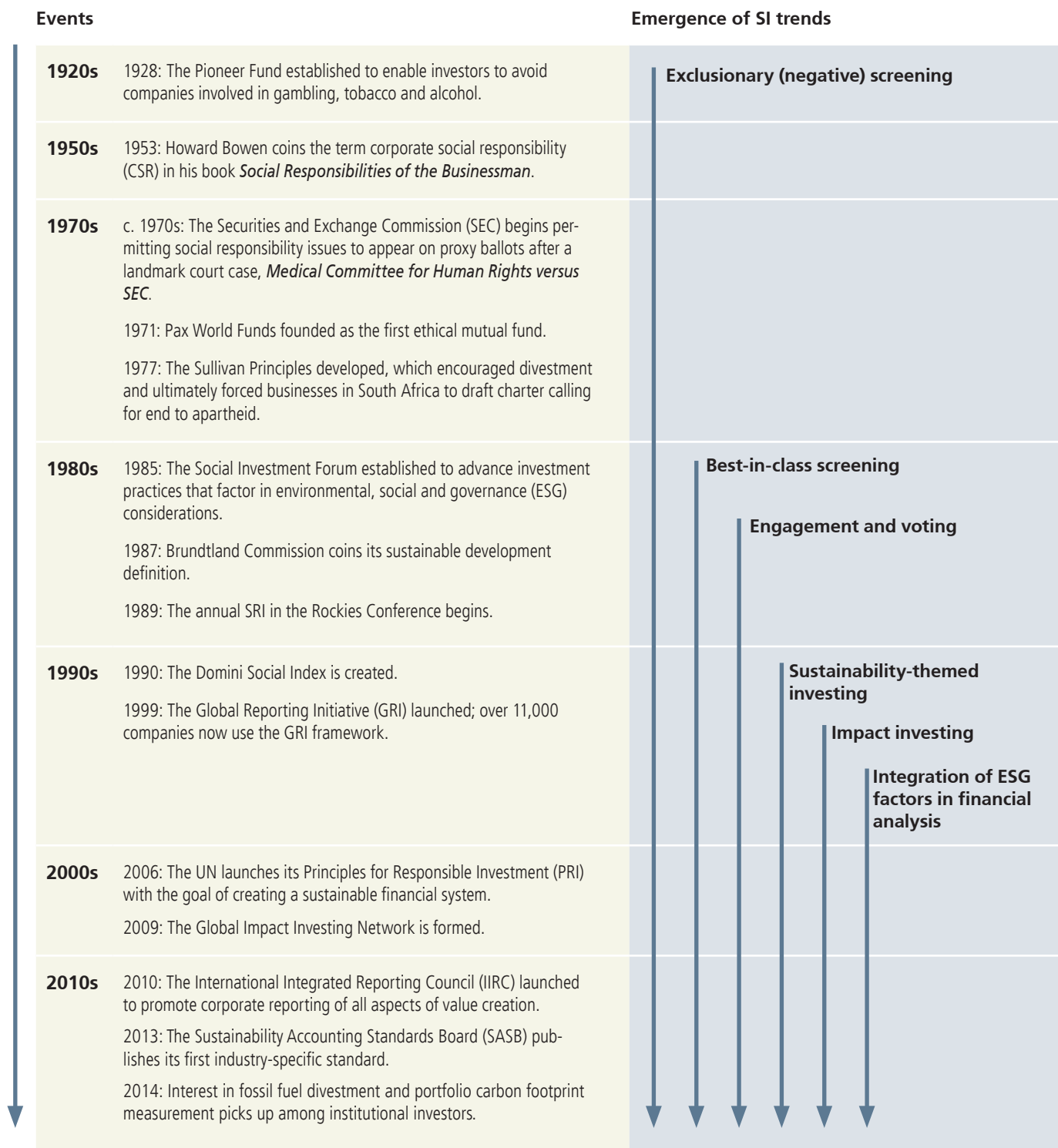
**Rick:** Well, first I think it is important to note that the impact space provides a level of risk capital that the market is not providing. I think the real need in the marketplace and where impact investors really make a difference is by being willing to back an entrepreneur at an early stage. That is a place where entrepreneurs do not have a great deal of access to capital. A lot of the entrepreneurs with whom we invest have a level of persistence that helps their company get through the peaks and valleys that all startups face. Then, on the other hand, when it comes to investing in listed markets, we believe that

you have to go with a diversified portfolio. In our family's foundation, we tend towards socially responsible investments and delegate those decisions to fund managers whose values are aligned with ours.

**John, how is the acceptance of sustainable investing in your surroundings?**

**John:** I can't speak for the rest of the nation, but we have a lot of people here in Seattle who are very environmentally concerned; they are concerned about how animals are being treated in the world. It is just that there is a heightened awareness here. People are really big into hybrid vehicles; you see them all over the place here. People want to stop global warming, and make a difference with what they do. People who have that kind of ethical concern are very open to a socially conscious investing approach.

## Evolution of sustainable investing (SI)

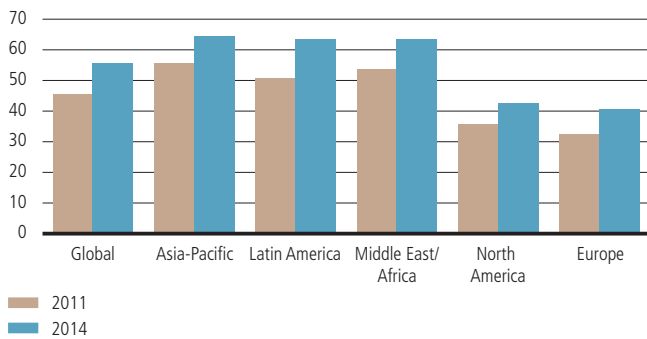


Source: UBS

# Chartbook

**Fig. 3: Consumers increasingly willing to pay for positive impact**

Percent willing to pay extra for products and services from companies committed to positive social and environmental impact



Source: Nielsen Global Survey of Corporate Social Responsibility, Q1 2014

**Fig. 4: UN Principles for Responsible Investment**

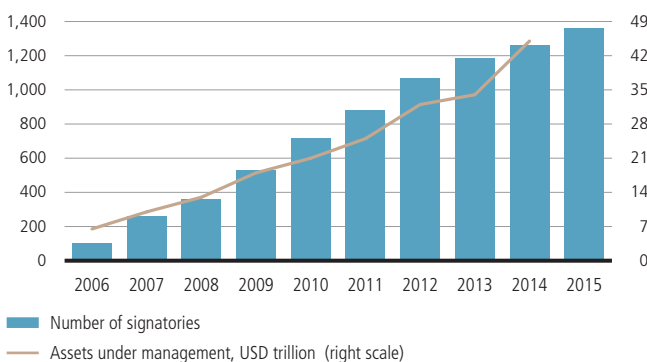
1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles with the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

Source: UN Principles for Responsible Investment

Note: ESG = environmental, social and governance

**Fig. 5: Growing number of investors committed to sustainability**

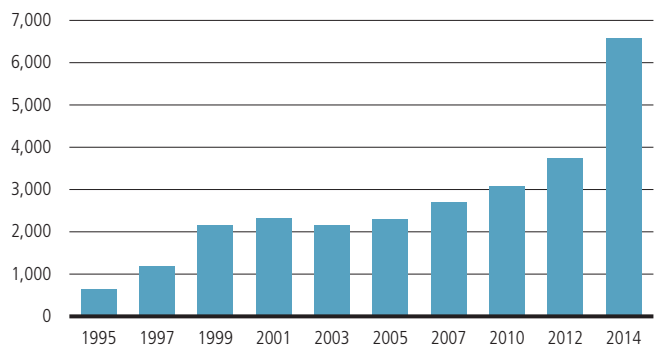
UN Principles for Responsible Investment signatories and assets



Source: UN PRI, UBS, as of 2 March 2015

**Fig. 6: SI assets in the US**

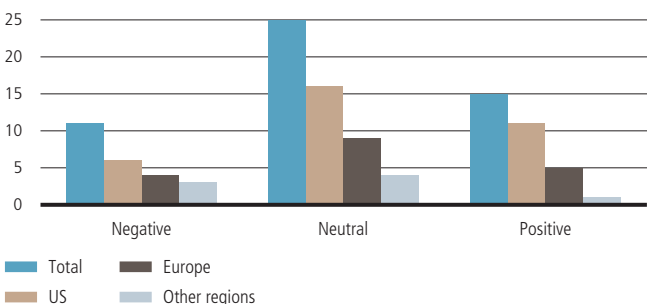
USD billion



Source: US SIF, as of 2014

**Fig. 7: Academic studies on relative performance of SI show inconclusive picture**

Number of studies showing positive, neutral and negative performance of SI versus conventional investments

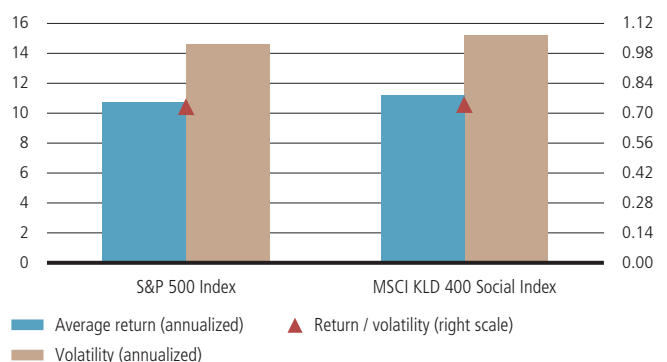


Source: UBS, 2014

Note: Only includes studies published 2000 or later

**Fig. 8: SI and conventional investing perform similarly**

April 1990 – February 2015, in %



Source: Bloomberg, as of February 2015



# Sustainable investing approaches

## Building blocks of a sustainable investing (SI) framework

**Not everything that can be counted, counts; and not everything that counts can be counted.**

William Bruce Cameron, sociologist

Having discussed what drives investors to SI and what they seek to achieve through such a strategy, we now turn to available approaches. UBS CIO has developed a framework to guide investors on how it fits into the overall investment advice picture (see Fig. 9).

The CIO framework comprises three main approaches: Exclusion, Integration, and Impact Investing. These can be integrated into an asset allocation and portfolio construction process that is common to both conventional strategies and SI. The two additional features – sustainability-themed investing and shareholder engagement – can be incorporated across the three main approaches.

### **Delineation with related areas**

While SI incorporates sustainability considerations into investment decisions, conventional approaches generally do not. In conventional portfolios, when such considerations do enter the equation, they are typically not explicitly acknowledged, or the affected assets represent a small fraction of the portfolio. Later, we discuss how it is possible to include sustainability-oriented investment themes as a small fraction of an otherwise non-SI portfolio.

SI and philanthropy differ in their profit motive. While some SI activities seek to achieve a positive social and/or environmental impact, the profit motive is nevertheless always present. Philanthropy does not include this motive.

## Approaches to sustainable investing – three pillars

### Exclusion: Achieving peace of mind

This traditional and probably still most common approach excludes individual companies or entire industries from portfolios if their areas of activity conflict with an investor's values. This process, called exclusionary or negative screening, can be quite flexible. It can rely either on standard sets of exclusion criteria or be tailored to investor preferences. For instance, investors may wish to exclude companies with 5% of sales or more generated from alcohol, weapons, tobacco, adult entertainment or gambling – so-called "sin stocks." Some faith-based investors also exclude companies involved in contraception and abortion-related activities.

In the case of government bonds, investors may seek to avoid an entire country based on the sovereign's compliance with select international standards (e.g. human rights or labor

standards). Note that there can be some regional variation about the desirability of excluding certain activities such as nuclear power or genetically modified organisms (GMOs). The exclusion approach can also be applied in combination with the integration approach, discussed below. In general, one of the major criticisms of this approach is that it reduces the investable universe.

### Integration: The combination of sustainability and financial analysis

This approach encompasses techniques that combine environmental, social and governance (ESG) factors with traditional financial considerations to make investment decisions. This broad category includes two specific approaches that are often blended in practice. Compared to exclusion, both approaches generally lead to portfolios with a more balanced sector composition.



**Fig. 9: UBS sustainable investing framework**

	Conventional investing	Exclusion	Integration	Impact investing	Philanthropy
		Sustainable investing			
<b>Desired outcome</b>	Seeks to achieve competitive risk-adjusted financial returns			Seeks to achieve a positive social or environmental impact	
<b>Additional dimensions</b>		Shareholder engagement			
		Sustainability-themed investing			
<b>Approach</b>	Little or no explicit focus on SRI/ESG criteria.	Screen and exclude companies or sectors that do not meet certain social, environmental or ethical criteria	Focus on securities with strong environmental, social and governance characteristics in combination with attractive financial fundamentals	Investments made with the explicit intention to generate a measurable social and environmental impact alongside a financial return	Charitable giving based on an altruistic desire to improve human welfare
<b>Examples</b>		Tobacco, alcohol, adult entertainment, gambling, weapons, animal testing, genetically modified organisms, etc.	Funds that integrate financial and non-financial (ESG) factors. Listed equity themes, e.g. water scarcity, clean tech	Companies, structures, organizations, and funds investing with impact intent	Charitable foundation

Source: UBS

1. *Positive screening a.k.a. best-in-class screening* uses ESG performance criteria and financial characteristics to select the best companies within an industry or sector, usually relying on a sustainability rating framework. This is usually a more knowledge-intensive process than exclusionary screening because it requires understanding which factors are relevant for each industry and evaluating individual issuers on each of these factors.

2. *ESG integration*, unlike positive screening, seeks to incorporate material ESG risks and growth opportunities directly into traditional security valuation (e.g., through inputs such as earnings, growth or discount rates) and portfolio construction. This approach has gained traction in recent years and is based on the premise that additional ESG information not covered by traditional analysis could have an impact on the long-term financial performance of a company. ESG integration involves understanding how companies handle social, environmental and governance risks that could damage their reputations and whether they are positioned to capture ESG opportunities that could give them a competitive edge.

**Impact investing: Making a difference**

Impact investing explicitly seeks to generate a positive social or environmental impact alongside a financial return, unlike other SI approaches, where progress on social and environmental issues may be a by-product of financial enterprise. The niche market of impact investing is growing fast. Examples include community investing, variants of microfinance, as well as private equity-like deals investing in such sectors as education, healthcare, basic infrastructure and clean energy.

In the ongoing debate about how strict the definition of impact investing should be, some practitioners are inclined to require financial returns to be contingent upon a measurable social or environmental outcome. We believe that a broader and more flexible approach will be needed to accommodate the growth of impact investing.

Our solution delineates “mainstream” and “catalytic” categories of impact investing, based on nine criteria (see box below). Mainstream impact investments must fulfill four of the criteria, including that of explicit intention to generate a social and environmental impact alongside a financial return. Catalytic

impact investments, in contrast, must meet all nine criteria and should achieve a transformational impact beyond their designated project. Illustrative transformations include altering the behavior of non-impact-motivated participants within the targeted sector, or broadening impact investing's appeal through financial instrument innovation. This dual approach should widen the investable universe for impact investing, while maintaining its integrity and accountability.

### Additional dimensions of SI

*Sustainability-themed investing* identifies themes related to environmental, social or governance factors, determines which industries and companies are positioned to benefit from these trends, and constructs portfolios that factor in such insights. Examples of such themes include water and waste management, food scarcity, energy efficiency or climate change on the environmental side; supply chain management or access to finance, housing, education and healthcare on the social front; and board diversity or corporate transparency as far as governance is concerned. By directing assets to these themes, investors can pursue return opportunities and express their interests with satellite investments. The thematic angle can also help populate core portfolio investments or inform the selection of impact investing vehicles. We therefore consider it integrated into the three approaches described above as a building block. For example, within impact investing, a private equity fund may invest in educational ventures, a typical SI investment theme. Within an integration approach, an ESG fund manager may select companies based on their resource efficiency or board

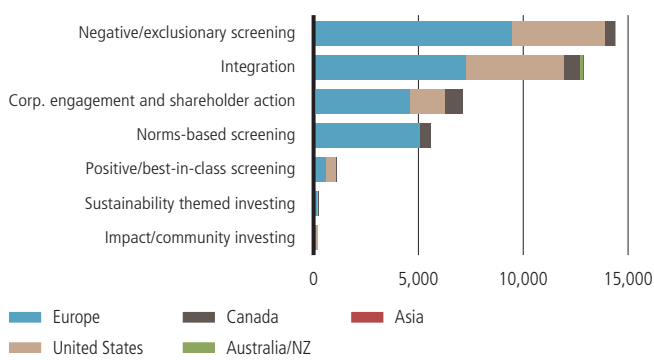
diversity. Finally, within an exclusion approach, an investor may decide to divest from coal companies based on views about the climate change theme. When structured as stand-alone investments, such themes can be included even in non-SI portfolios.

*Shareholder engagement* (also known as activism) is a common feature of professionally managed sustainable investing. It can be combined with the various approaches above to leverage shareholder influence and attempt to shift corporate behavior toward greater compliance with ESG principles. Influence can be exerted by investors through direct communication with corporate management or by filing shareholder proposals and proxy voting. Sustainability-focused fund managers are often active in this area. The influence of shareholder engagement on ESG issues has risen in recent years, the major categories of proposals being political activities of corporations, the environment, human rights/diversity, and governance.

Although positive impact is often viewed as a distinguishing feature of impact investing, *shareholder engagement can be an effective instrument to exert positive impact* through investments in listed securities through the induced change in behavior of the targeted corporations.

**Fig. 10: Exclusionary screening and integration dominate**

SI assets under management, in USD billion



Source: Global Sustainable Investment Alliance (GSIA), 2014

## Criteria for impact investments

- Investment generates product or service with positive impact on society or environment.
- Value chain with no adverse impact on society and environment.
- Project team is credible.
- Project implementation plan is credible.
- ESG-audited
- Social impact measurement
- >75% of fund investment on impactful activities
- Global assets under management <USD 30bn
- Catalytic





# Executing your sustainable investing strategy

Questions to consider prior to implementing

**Though no one can go back and make a brand new start, anyone can start from now and make a brand new ending.**

Carl Bard (1907–1978), theologian

To build an SI portfolio, we first consider how different asset classes can be viewed from a sustainability perspective, in both public and private financial markets. Investors must make a few simple decisions before engaging in this area, and these choices affect the resulting asset allocation approach. We then touch on several critical implementation questions.

## **From sustainable equities to sustainable portfolios**

Equities have been the asset of choice traditionally for SI. Here is where the greatest level of maturity has been reached. Yet even within some equity markets, such as emerging markets, the approach is still difficult to implement due to a greater scarcity of data and investable solutions that credibly incorporate the relevant features.

The trend is for investors to look for SI solutions beyond equities to ensure that their entire portfolio is structured in a way that incorporates ESG considerations. Each asset class presents opportunities, but also limitations that investors must keep in mind.

Overall, equities and fixed income lend themselves well to SI. Hedge funds and private markets exhibit a number of implementation hurdles, but interest is growing. Commodity investments are often problematic from a sustainability perspective.

### Fixed Income

SI considerations are just as important in the world of fixed income as they are for equities. In a sense, ESG risk analysis, with its emphasis on protecting portfolio downside, is especially well suited for integration in fixed income investing. The corporate failures and associated bond defaults that have taken place due to poor corporate governance in recent years are reminders of the usefulness of such criteria.

For corporate issuers, the same SI criteria that are relevant for a company's stock can be applied to its debt (exclusion and integration approaches). How one judges sovereign debt securities, however, is less well established. Still, there are some straightforward examples of exclusion criteria that could help screen out certain governments, such as: military conflict; human rights track record; access to healthcare, clean water, education and other basic needs; income inequality; and the health of the environment.

Fixed income is well suited to allow investors to have an impact with their portfolios (see impact investing on pg. 16). An interesting development is the emergence of a market for green bonds (see box at right), which now, beyond traditional multilateral issuers, also includes a growing amount of corporate issuance.

Overall, while fixed income SI is by no means as developed as it is for equities, the growing number of dedicated investment managers and the emergence of new segments of the bond market mean that ESG investors can confidently include the asset class in their portfolios.

### Commodities

Commodities are a challenging asset class from an SI point of view. The production of physical commodities is often associated with negative environmental side effects, resulting from mining, drilling, land clearing, water use and generally higher levels of pollution. Another notable concern in mineral production and distribution is the violation of human rights in conflict areas. Finally, financial investments in commodities, which are often carried out through derivatives, have been blamed for increasing the price volatility of basic necessities, such as food and energy. Given these issues, how investors view these concerns will determine their inclination to include commodity investments as an asset class in an SI portfolio.

### Alternative Investments

Alternative investments (AI) such as hedge funds and private markets share common characteristics that create a mixed appeal as vehicles to implement SI strategies. On one hand,

both are inherently active strategies, which places fund managers in a strong position to incorporate the relevant criteria. However, both typically exhibit reduced transparency and reporting requirements, a significant factor enabling attractive risk-adjusted returns. For example, private equity financing is associated with reduced reporting and scrutiny on underlying companies compared to public listings. Implementing SI strategies and the associated transparency requirements may thus be challenging and costly to implement within AI, and may prove difficult to justify, notably in the case of fixed income strategies such as private debt.

### Hedge funds

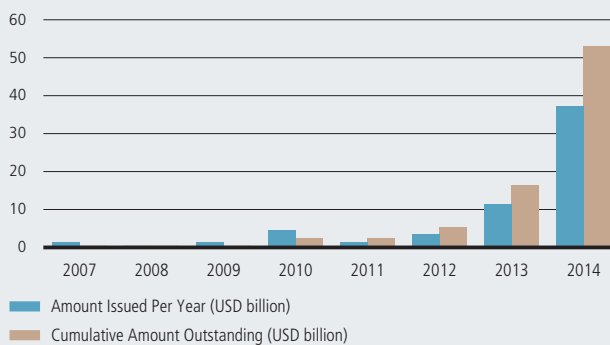
Hedge funds are heterogeneous in their investment strategies. Incorporating SI presents challenges from a performance

## Green bonds

The emergence of the green bond market was originally spearheaded by the World Bank starting in 2008 to support lending for eligible projects that seek to mitigate climate change or help affected people adapt to it. Over the last two to three years, corporations have started issuing green bonds as well, using the earmarked proceeds to finance environmentally friendly projects. According to the Climate Bond Initiative, a non-governmental organization (NGO), the issuance of green bonds in 2014 reached nearly USD 36.6bn, while total issuance in 2013 amounted to USD 11bn. Despite significant growth, this market is still in its infancy.

**Fig. 11: Green bond market taking off**

Annual and cumulative issuance in USD billion



Source: The Climate Bonds Initiative, as of 31 December 2014





and flexibility standpoint. Certain strategies, such as “equity hedge” (equity long-short), are better suited to incorporating SI criteria than others. Moreover, hedge funds may use techniques and instruments which can exert a controversial impact on target companies or market stability. While applying SI criteria is not inconsistent with hedge funds’ mandates, it introduces constraints on hedge funds’ opportunity set and may impact the flexibility of their approach. This explains why the industry has been relatively slow to embrace related strategies.

#### *Private markets*

Private markets funds finance mostly small- and medium-sized companies through private equity, private debt and real asset (such as private real estate and infrastructure) strategies. Some factors support the incorporation of SI in private markets. The multi-year time horizon of private markets coincides well with the long-term orientation of SI strategies. Moreover, fund managers proactively advise their companies and benefit from powerful corporate governance instruments such as a strong presence on the board, voting and veto rights and the use of specialized investment instruments (convertible debt and preferred shares). Their clout and expertise could support implementation of an SI framework.

However, various hurdles limit SI use in private markets, and the approach remains at an early stage of development and adoption. Some typical SI objectives might be incompatible with venture capital investments in dual use (military and civilian) technologies or in biotechnologies (such as stem cells or genetically modified organisms) that are still heavily debated. Moreover, leveraged buyouts can involve layoffs, which may be at odds with certain social goals.

Nevertheless, as discussed in Chapter 2, private markets funds have established themselves as a preferred financial structure for impact investing, with fund managers using their private markets toolbox to pursue extra-financial goals. Private markets thrive through innovation. They already offer investment solutions ranging from venture philanthropy to social impact funds and microfinance. These instruments offer interesting perspectives for investors willing to accept ESG constraints.

#### *Real estate*

Both physical and listed real estate offer a broad and fast growing SI universe. Property developers, investors and private as well as public property companies have shown strong and growing interest in such projects with a particular focus

on low energy consumption (the highest energy standard being fully autonomous buildings). These types of real estate strategies offer advantages such as energy efficiency and thus lower costs, a higher building quality and an improved landlord image. Growing demand is underpinned by various global initiatives. For example, the Global Real Estate Sustainability Benchmark (GRESB) survey ranks funds and their managers into four categories, from those just starting to develop sustainability policies to top performers which have integrated the

## The trend is for investors to look for sustainable investing solutions beyond equities.

measurement and management of environmental key performance indicators into their investment processes. Moreover, building standards such as the Leadership in Energy and Environmental Design (LEED) have been created to increase transparency internationally.

### Building an SI portfolio

In creating an SI portfolio, investors must keep in mind the same fundamentals of portfolio construction as with any traditional investment strategy. The objective of achieving an attractive risk and return mix based on a portfolio well diversified across different asset classes is key. To achieve this goal, we at UBS recommend constructing portfolios based on our long-term strategic asset allocations (SAAs), spreading capital across diverse assets such as equities, bonds, hedge funds, etc.

As the start of the chapter suggests, SI is not an asset class. It is an investment style that can be applied across a variety of asset classes. However, its availability, in particular for certain approaches, can still be limited in some asset classes. For example, impact investments are for now predominantly found in private equity or debt asset classes and less so in liquid equities. Investors must assess for each asset class whether solutions exist and whether they adequately incorporate the investor's standards and specific preferences for SI.

If enough asset classes are investable using an SI approach, investors can follow the same fundamental principles for portfolio construction as for any conventional strategy. If not, some adjustments are needed.

### How strictly to implement SI in a portfolio?

Investors can follow either a "pragmatic" or a "strict" approach. The "pragmatic" approach involves pursuing an optimal asset allocation target derived from the conventional investment process, investing with SI solutions in all asset classes for which such an implementation exists and relying on conventional solutions for the remaining asset classes. While the resulting portfolio is only partially invested in SI, the benefits of an optimal asset allocation are preserved.

A "strict" approach has a primary objective of being fully invested in SI and excludes asset classes which do not currently offer adequate solutions. This requires developing revised asset allocation guidelines built around the asset classes available for SI. The advantage is full consistency between the portfolio and the investor's preferences and motivations for SI (see Chapter 1). However, one has to consider that, depending on the importance of the excluded asset classes, the resulting portfolio may be somewhat less diversified.

### Liquid versus illiquid investments

Illiquid investments such as private equity generally lock up investors' funds for several years and compensate investors by offering higher returns compared to their listed counterparts. These can be beneficial elements in a portfolio, but each investor has a limit regarding the amount of illiquid investments as dictated by liquidity needs.

This has implications for asset allocation and for the ability to implement certain SI strategies. The purest form of impact investing is currently found predominantly in illiquid asset classes such as private equity. Therefore, investors with high liquidity needs may find it difficult to embrace impact investing fully. They might need to focus on diluted versions of impact investing and more liquid styles such as integration or exclusion.

The corollary to this is that pursuing significant allocations to impact investments, for example, may result in a portfolio holding a large amount of illiquid asset classes.

### Personalizing an SI strategy

There are several additional dimensions along which investors can personalize their strategy.

*Sustainability themes* that resonate with investors can be included in the portfolio. The choice here is whether to target exposure to themes, for example as satellite investments, to

rely on preferred themes to select impact investing opportunities, or to ascertain that themes of interest are being reflected in the holdings of a specific third party manager. Such themes often focus on areas of scarcity and highlight solutions to alleviate it (see box on pg. 24). Note that sustainability-themed investment solutions do not always incorporate more general SI considerations.

The desired extent of *shareholder engagement* that invested assets facilitate is another consideration. Individual investors wishing to achieve a positive impact in liquid securities can do so through delegation of money management to a third party that is active in shareholder engagement.

Finally, an investor must decide *how much active management* should be integrated into the portfolio. While this decision does not pertain specifically to SI, it is relevant insofar as the majority of investment vehicles tend to be actively managed in this area. This has the benefit of enabling the investor to

focus on managers who approach themes and engagement in their preferred way. Passive solutions such as exchange-traded funds are growing, however, driven by demand from institutional investors. They are quite popular as a means to target specific sustainability themes.

By carefully considering these options and choosing the right combination of the approaches we've highlighted in this report, investors can decide in what way their investments will help address the challenges to humanity presented in the introduction.



## Sustainability-themed investing: Some examples

### Environment

**Water scarcity:** Clean water supply is constrained by both the lack of infrastructure in emerging markets and aging water infrastructure in developed regions. Climate change, urbanization and industrial activities in emerging economies are also creating a negative impact on water supply. Water risk can affect business operations in any of the following ways: plant shutdowns due to lack of water supply, and higher agricultural or basic material input costs if the supply chain is disrupted. Investing in water treatment, storage and distribution infrastructure are ways to alleviate water scarcity. Investments in more efficient irrigation technology, as well as desalination projects, can also be considered.

**Energy efficiency:** Energy efficiency improvements yield both energy savings and reduced carbon dioxide emissions. In recent years, stricter regulation with a view to protecting the environment and securing the supply of energy has been a powerful driver, boosting efficiencies in buildings, autos and power generation. Energy efficiency addresses a whole range of issues, such as the sought-after reduction in the use of fossil energy sources and the lack of storage technologies for renewable energies. Companies manufacturing energy-efficient equipment benefit from this trend.

**Food scarcity:** While providing humankind with enough food has been a challenge throughout the ages, rapid population and economic growth in emerging economies, combined with a shift toward higher protein, meat-based diets

in these regions are a root cause for a stretched human food supply system. The two main channels to alleviate the problem are food waste reduction and increasing agricultural productivity. Agricultural productivity can be increased through more advanced equipment, better irrigation, fertilizer, and crop protection. Investors can look for companies active in these areas to gain exposure to the theme.

### Social

**Labor standards and supply chain management:** The issue of labor standards within companies or in their supply chain has gained increased attention recently. It is of material relevance for companies as it relates to one of their key assets: human capital. Companies that fail to manage these issues properly may risk facing labor shortages and even strikes. They may also be at risk of losing their legitimacy with consumers and facing boycotts.

### Governance

**Board diversity:** While achieving greater gender balance and minority representation in companies is often viewed as an issue of fairness, an economic case can be made as well. For instance, regarding diversity at the level of corporate boards, existing academic evidence indicates that greater diversity can improve how boards function and be associated with better financial performance.

**Fig. 12: Increased efficiency can help alleviate environmental scarcity**



Source: UBS

# Outlook and conclusions

*There are three steps in the revelation of any truth: in the first, it is ridiculed; in the second, resisted; in the third, it is considered self-evident.*

Arthur Schopenhauer (1788–1860), philosopher

**Sustainable investing has evolved** from a niche discipline to an established field. It has now reached a level of maturity and acceptance fueled by changing societal expectations, a growing investor base, greater transparency and engagement by corporations, and an improved analytical infrastructure. It now capably fulfills the needs of multiple types of investors, while offering performance comparable to conventional approaches.

Investors approach SI for different reasons. Various solutions have emerged to satisfy this range of motivations – whether exclusion, integration or impact investing approaches. UBS CIO includes all of these approaches in its coherent framework. Investors must answer key questions to help guide their decisions before implementing such a strategy.

We believe that the SI movement is not only here to stay, but will also continue to grow faster than the investment industry as a whole. The shift in societal expectations currently underway is likely to extend beyond the next decade, driving a widespread adoption of SI principles throughout the investment community.

We expect this growth to be associated with an expansion in ESG integration within investment management, gradually embedding it within standard money management practices. We also think an expansion in the number and variety of impact investing options is likely, and that measuring social impact will become more established and effective.

For investors, this means SI will continue growing in appeal and sophistication, simplifying inclusion in diversified portfolios.



# Disclosures

## Emerging Market Investments

Investors should be aware that Emerging Market assets are subject to, among others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and sociopolitical risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. WMR generally recommends only those securities it believes have been registered under Federal U.S. registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as “Blue Sky” laws). Prospective investors should be aware that to the extent permitted under US law, WMR may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.

For more background on emerging markets generally, see the WMR Education Notes “Investing in Emerging Markets (Part 1): Equities,” 27 August 2007, “Emerging Market Bonds: Understanding Emerging Market Bonds,” 12 August 2009 and “Emerging Markets Bonds: Understanding Sovereign Risk,” 17 December 2009.

Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Sub-investment grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher-yielding bonds for shorter periods only.

## Nontraditional Assets

**Nontraditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments).**

Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that

include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments; there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-US securities and illiquid investments.

# Disclaimer

The views of third party, non-UBS personnel expressed in this report do not necessarily reflect the views of UBS or any of its business areas, including Wealth Management Research. This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results.

Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS and its affiliates). All information and opinions as well as any prices indicated are current only as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria. At any time UBS AG and other companies in the UBS group (or employees thereof) may have a long or short position, or deal as principal or agent, in relevant securities or provide advisory or other services to the issuer of relevant securities or to a company connected with an issuer. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify.

UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas,

units, divisions or affiliates of UBS. Futures and options trading are considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in FX rates may have an adverse effect on the price, value or income of an investment. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we would recommend that you take financial and/or tax advice as to the implications (including tax) of investing in any of the products mentioned herein. This document may not be reproduced or copies circulated without prior authority of UBS or a subsidiary of UBS. UBS expressly prohibits the distribution and transfer of this document to third parties for any reason. UBS will not be liable for any claims or lawsuits from any third parties arising from the use or distribution of this document. This report is for distribution only under such circumstances as may be permitted by applicable law.

USA: Distributed to US persons by UBS Financial Services Inc., a subsidiary of UBS AG. UBS Securities LLC is a subsidiary of UBS AG and an affiliate of UBS Financial Services Inc. UBS Financial Services Inc. accepts responsibility for the content of a report prepared by a non-US affiliate when it distributes reports to US persons. All transactions by a US person in the securities mentioned in this report should be effected through a US-registered broker dealer affiliated with UBS, and not through a non-US affiliate.

© UBS 2015. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

## Endnotes

<sup>1</sup> Brundtland Commission, Our Common Future, 1987.

## References

UN Global Compact-Accenture, "The UN Global Compact-Accenture CEO Study on Sustainability 2013, Architects of a Better World," (2013)

Nielsen, "Doing Well by Doing Good," Nielsen Global Survey of Corporate Social Responsibility, Q1 2014, June 2014.

KPMG, "The KPMG Survey of Corporate Responsibility Reporting 2013," (2013)

Glenn, J., T. Gordon, and F. Florescu, "2013-14 State of the Future," The Millennium Project, Washington, D.C., 2014.

Kathleen A. Farrell & Philip L. Hersch, Additions to Corporate Boards: The Effect of Gender, *Journal of Corporate Finance* 11, (2005)

Joecks, Jasmin, Pull, Kerstin and Vetter, Karin, Gender Diversity in the Boardroom and Firm Performance: What Exactly Constitutes a 'Critical Mass'? (February 22, 2012). Available at SSRN: <http://ssrn.com/abstract=2009234>



UBS Financial Services Inc. is a subsidiary of UBS AG.  
[www.ubs.com/financialservicesinc](http://www.ubs.com/financialservicesinc)

