Wealth can deliver more than financial returns

by Mario Marconi, UBS Wealth Management

Since the turn of the millennium, we have witnessed imploding asset bubbles in technology and housing, a long list of governance lapses and accounting scandals, and the greatest financial crisis of our time. These developments led to great social pressure and a baseline consensus among many investors that the unsustainable economic and industry trends of recent years cannot be allowed to continue. The social fallout is just too great. However, investors have the power to direct their capital into investments that not only deliver returns but also make a positive impact on the world around them.

Today's economic circumstances demand a shift. The global economy faces threats from climate change, water scarcity, the depletion of other important natural resources, and other human-induced factors, which, if not managed properly, will accelerate as the world's population grows. Thus social and environmental issues are no longer just moral considerations – they are economic imperatives. Yet they also present a whole host of new opportunities.

Our clients increasingly recognise that investments can drive social and environmental change and they want to take responsibility for that change. We believe that as a bank we have an obligation to provide them with the tools to do this.

Why invest sustainably?

Besides the traditional investment criteria such as performance, liquidity and security, sustainable investing also considers environmental, social and governance factors into the investment decision-making process. By considering these additional factors we believe that over the long term these investments are better placed to weather the storms of the future thereby creating and preserving wealth for investors.

Sustainable investing has two main benefits for an investor, be it a private or an institutional investor:

Risk performance profile

Together with sound financial analysis and good portfolio management the integration of sustainability criteria can improve the risk return profile of the portfolio.

Impact

Sustainable and measureable positive effects can be achieved by investing capital into the solution of ecological and social problems.

Not including social and environmental aspects can have negative effects on the reputation and performance of a company in the future and could negatively impact the overall return of a portfolio. Companies who do not do their homework and fail to proactively manage social and environmental challenges could generate lower returns in the long term.

For example, a textile company which ensured that labour conditions in their production process were good is in a much better position when facing fair trade and sustainable production requests as producers move away from pure profit maximisation. These practices also minimise potential reputational damage and adhere to the labour standards expected from customers.

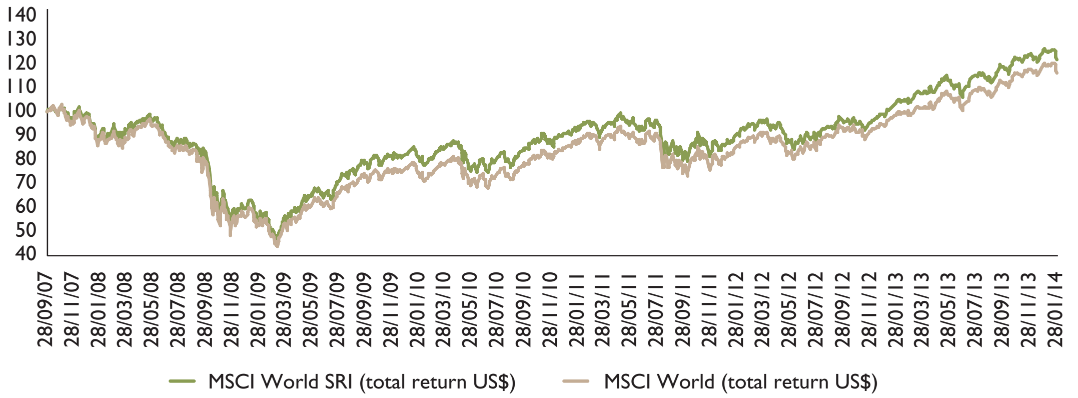
Sustainability as a competitive advantage

Social and environmental changes will have a major impact on the way we live and do business in the future. For investors these aspects therefore need to start playing an important role in long-term business considerations and as a consequence in their investment approach. Sustainability will become a factor of competitive advantage. Companies who incorporate sustainability, even out of economic self-interest, will get a win-win result for both their shareholders and the greater public.

The crucial question is "can my wealth deliver more than financial returns? And is my money being invested in a way that serves my long-term financial interests?"

By investing wisely in people and companies who believe a sustainable approach to business is the right approach, and by focusing on financially attractive companies that demonstrate leading social, environmental and governance practices within their industry, we have the potential to help the world and preserve the planet.

Figure 1: Comparison of the MSCI World SRI and the MSCI World



Source: Datastream

Dispelling the myth – integrating sustainability goals does not come at the expense of performance

Academic research has proven that the integration of sustainability criteria does not necessarily lead to lower performance. On the contrary – its integration can lead to similar and even better performance.

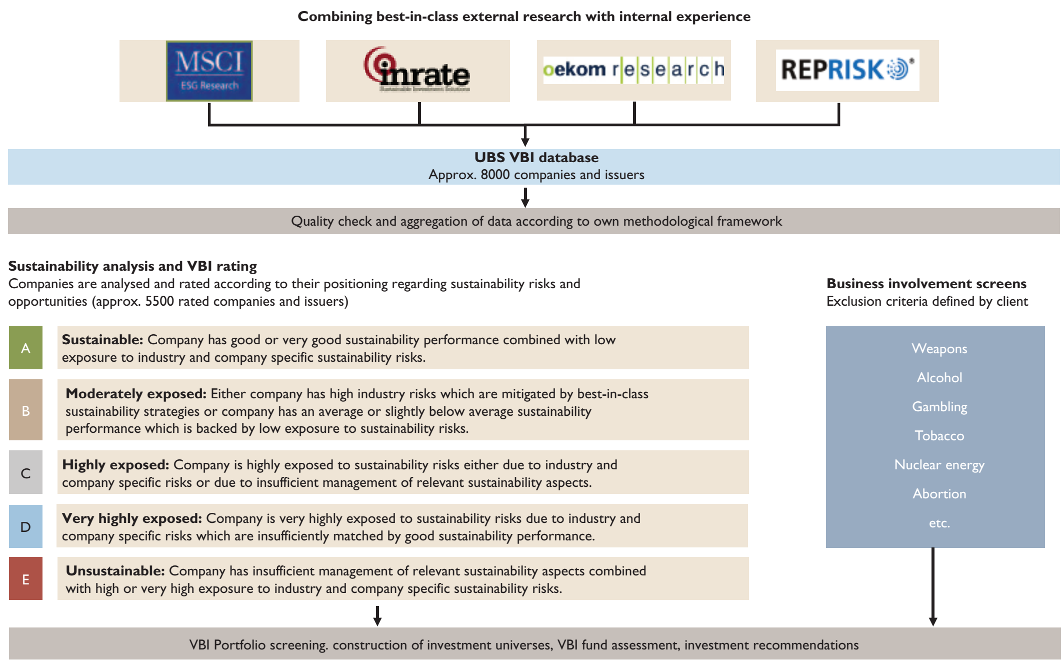
This thesis is also confirmed by the performance of various SRI indices, such as the MSCI World SRI Index or FTS-E4Good Index, both of which perform roughly in line with their "conventional" peers. Another illustration of this similar performance is a comparison between the MSCI Europe and MSCI SRI Europe indices.

Of course, placing too many constraints on a portfolio may indeed cause significant deviations from a benchmark. At the same time, it has been proven that integrating environmental and social risk and opportunity factors can help construct very attractive portfolios.

How we help clients to invest sustainably

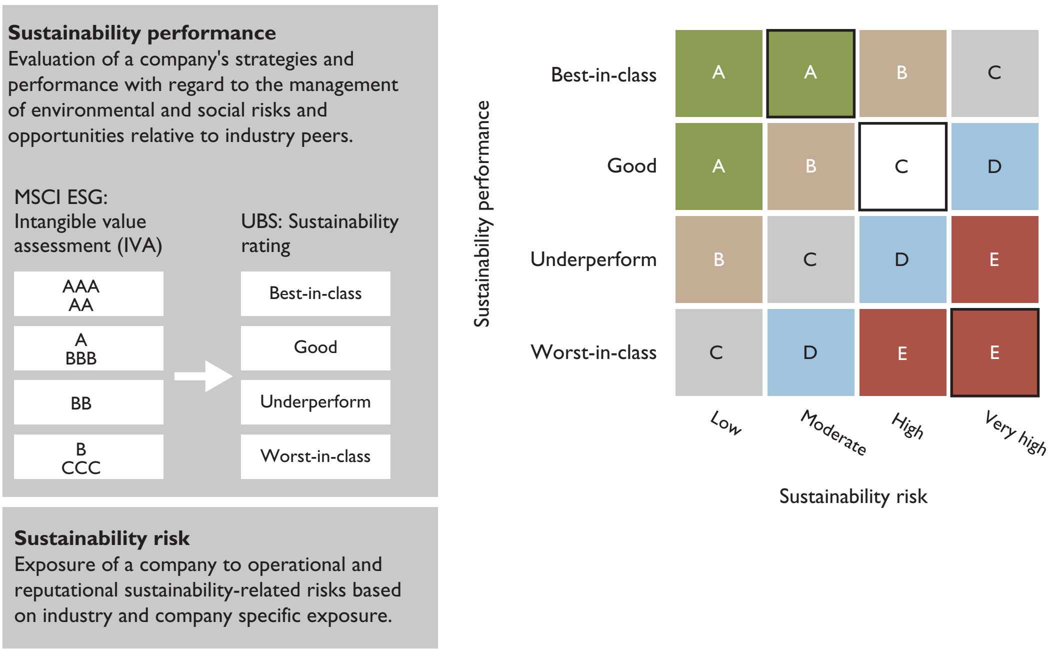
The UBS Values-Based Investing team is a solution provider with the mission to give all our clients the opportunity to get more than financial returns from their investments. We have developed a state of the art advisory and investment approach to give all our clients the opportunity to invest sustainably and

Figure 2: Values-based investing portfolio screening process



Source: UBS Wealth Management

Figure 3: Sustainability and risk



Source: RepRisk, MSCI ESG Research, UBS own research

make a positive impact on society.

The process begins with a discussion with the client to establish his or her investment goals, values and interests and which sustainability topics (environmental, social or governance) are most important. Then a sustainability analysis of the positions within the portfolio is conducted and each is given a sustainability rating. This rating is derived from our own analysis in conjunction with research from four different sustainability rating agencies, namely MSCI ESG Research, Inrate, Oekom research and RepRisk.

Each position is checked according to the following criteria:

Performance-sustainability analysis

The company's strategies and performance are evaluated by taking into account the management of environmental and social risks and opportunities relative to industry peers. Consideration is also being given to whether a portfolio offers access to business opportunities that arise from the solution of sustainability challenges, such as solutions to climate change, efficient supply of clean water, or sustainable social development.

Sustainability risk exposure

The exposure of a company to operational and reputational sustainability-related risks is analysed, based on industry and company specific exposure and involvement in controversies.

Exclusion criteria

The exposure of a portfolio to specific industries (e.g. weapons, alcohol, tobacco, etc.) is highlighted.

Overall assessment

On each portfolio an overall sustainability assessment is made. Opportunities for sustainable investment are highlighted, i.e. companies that have developed the strongest strategies to deal with environmental and social challenges in their industries.

This rating takes two dimensions into consideration, namely the sustainability performance and the sustainability risk.

The sustainability performance rates as to how well a company is living up to sustainability standards. It is split into the categories best-in-class, good, underperform and worst-in-class. The sustainability risk rates how heavily a company is exposed and can be influenced by sustainability issues.

Finding the right sustainable investment strategy

There are four main sustainable investment strategies to integrate environmental, social or governance criteria in investment decisions. These are:

- Negative screening
- Positive screening
- Community and impact investing
- Engagement

Negative screening excludes companies or sectors from a portfolio based on ethical, environmental or social criteria. This may be applied, for example, to companies involved in the manufacture or sale of weapons or those whose business practices have a highly negative impact on the environment. The most frequently used negative screens are tobacco, alcohol, gambling and weapons. Exclusion can also be done based on risk considerations. Cigarette makers or businesses that emit large volumes of carbon dioxide, for example, could come under additional pressure from regulators in the future, which in turn could affect their earnings.

Positive screening includes financially attractive companies with leading practices as measured by environmental, social and ethical criteria.

1. Thematic investing focuses on companies which offer innovative solutions to specific sustainability challenges, such as water scarcity or renewable energies. This approach offers a combination of the attractive return potential of growth companies with the opportunity to direct money towards solving the major challenges of our time. This strategy normally implies a bias towards small- and mid-cap companies.
2. Best-in-class aims to identify financially attractive companies that also demonstrate leading social, environmental and governance practices within their industries. This is based on the conviction that markets will reward sustainable business models and best practice over the long term. This approach is used to construct broadly diversified portfolios. As the basis for stock selection is normally a broad market index, companies chosen according to this approach tend to be large caps.

Community and impact investing can be viewed as targeted investing aimed at creating a positive social and environmental impact as well as generating returns. It includes investments that range from producing a return of principal capital to offering market-rate or even above-market financial returns. Community investing is specifically aimed at directing capital to communities that are underserved by traditional financial services. It supplies capital for small businesses and vital community services, such as child care, affordable housing and healthcare.

Engagement, or shareholder advocacy, refers to the practice of investors making use of their rights as corporate owners to enter into a dialogue with a company's board or management. In particular, large institutional shareholders such as pension funds, often use this approach, with the aim of influencing corporate behavior on environmental, social or ethical issues. Engagement can take many forms, ranging from dialogue with management to voting shares or issuing shareholder resolutions.

Helping clients to make an impact

From 2015 onwards, our sustainability ratings will become entirely integrated into our wealth management advisory processes. This will mean that clients will receive a Sustainability Health Check of their investment portfolios. By helping to shed light on how sustainable their investments are we can then advise clients on how to adopt strategies (above) to invest more sustainably. By working with our clients to achieve higher levels of sustainability we can impact the way we do business in the future.

At UBS we also have an Impact Investing advisory team which helps clients to map opportunities, provides a second opinion on existing investment opportunities, delivers workshops to help formulate an approach and structures investments. We also recently launched an Impact Investing SME Focus Fund. This is a fund of funds which invests in sectors and businesses that drive social or environmental change including healthcare, education, access to finance, basic infrastructure and agricultural/sustainable forestry.

Sustainable investing at the inflection point of becoming mainstream

Sustainable investing strategies have seen positive inflows over the past several years, outpacing the overall growth of assets under management in Europe and North America – the regions where sustainability has had its greatest uptake. In its 2012 review, the Global Sustainable Investment Alliance estimated the size of the sustainable investing markets at US$13.6 trillion globally, which represents more than 20% of assets under management in the regions surveyed. The sustainable investing strategies with the most invested assets are exclusion strategies and those that integrate sustainable criteria.

We expect assets under management in sustainable investing strategies will continue to grow in the coming years thanks to intensifying awareness among investors about environmental, social and governance concerns. We are also taking steps to mainstream sustainability factors in our own investment processes. Greater information and transparency on sustainability considerations will enable investors to better manage risk and assess how companies are creating and preserving value.

Overcoming mistrust

If the finance industry plays it right we can overcome much of the mistrust which has persisted since the financial crisis – as the Nobel prize winner

Rob Shiller said in his latest book – "we need to envision new ways to rechannel financial creativity to benefit society as a whole. Ultimately, Shiller shows how society can once again "harness the power of finance for the greater good."

Going forward, taking responsibility and contributing to society will become more important for banks and their employees.

As the world's largest wealth manager UBS is the custodian of a significant portion of wealth. As custodians and indeed managers of that wealth we have a duty of care to our clients, but does our duty of care extend beyond that? As the managers of such a large pool of money surely our responsibility extends to the wider world.

Taking responsibility

So the question is how can UBS conduct its wealth management operation more responsibly and go beyond standard CSR activities?

In my view the answer is to transform the way we do business and in wealth management that means the way we advise our clients to invest money. It is clear that delivering social change at scale will require more capital than philanthropy and public resources can provide. If we directed just 1% of our assets under management to doing good we could leverage significant capital.

We believe that by integrating sustainability into the overall investment approach we can ultimately increase capital flow to those industries and companies that have considered social and environmental factors in their business operations. In our view this is not only beneficial to the world but also to the investors as not only do those companies who have integrated social and environmental factors demonstrate risk-adjusted returns in line with the market over a reasonably long investment period but also deliver environmental, social and other added value.

About the author:

Mario Marconi has over 20 years of experience in the wealth management and investment banking industries. Prior to his function as Head of UBS Philanthropy and Values-Based Investing, his assignments included Head UBS Wealth Planning as well as the responsibility for a number of specialised services for Ultra High Net Worth clients. As an expert he has been featured on the topics of philanthropy and values-based investing in various television broadcasts, such as CNBC as well as numerous publications. Mario holds a degree in Economics from the University of Geneva and an MBA from IMD.

UBS Philanthropy and Values-Based Investing provides clients with the services and tools to deliver positive change through donations or investments. It provides thought leadership, advice, products and solutions helping clients with strategy formulation to implementation on the ground.

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