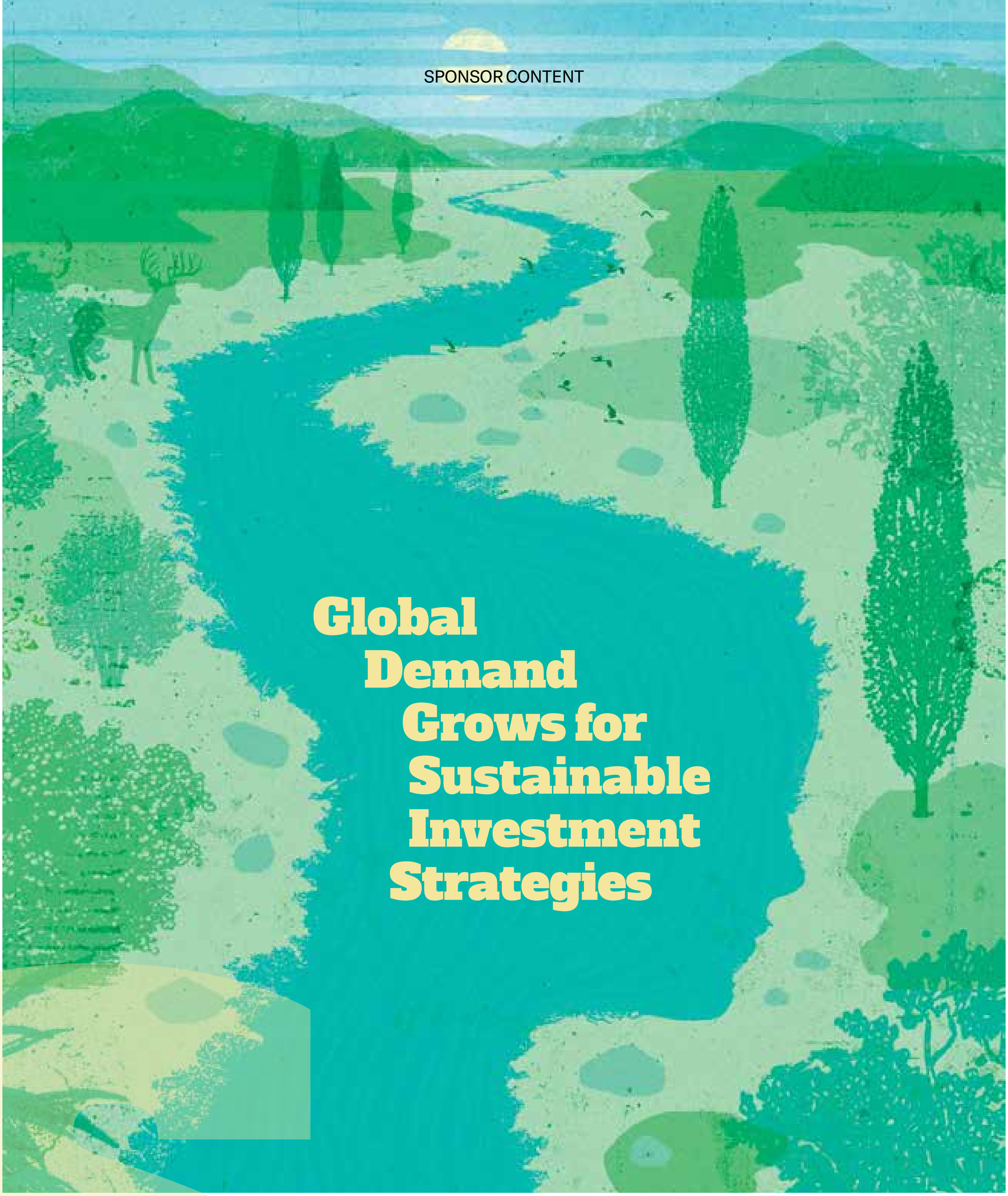

Global Demand Grows for Sustainable Investment Strategies

Socially responsible investing has been a theme in the global financial markets for decades. Some institutional investors use negative screens to exclude sectors like tobacco or alcohol, while others strive to support sustainability through investments in renewable energy, community housing, microfinance and other fields.

Today, a growing number of institutional investors and asset managers are focusing on integrating a company's environmental, social and governance (ESG) policies and practices with traditional financial analytic tools.

"We see ESG factors as a vital aspect of the investment decision-making process," says Cindy Rose, Head of Responsible Investing — Stewardship, Aberdeen Asset Management PLC. "Over the longer term, companies that manage their ESG opportunities and risks, along with their financials, will have a competitive advantage."

One indicator of that positive differential is the MSCI Emerging Markets ESG Leaders Index, which provides exposure to companies with high ESG performance relative to their sector peers. It has consistently outperformed the MSCI Emerging Markets Index for the past nine years. Through July 2017, the ESG index rose 13.83 percent

What Is ESG — and Why Is It Needed?

Analysis and consideration of environmental, social, and governance (ESG) factors are becoming more common throughout the investing world. But what exactly do we mean when we talk about ESG — and why should investors care?

First, let's talk about what ESG is not. Although integrating ESG into an investment approach can be viewed as responsible investing, it shouldn't be confused with socially responsible investing, or SRI. Criteria for SRI are overarching themes or client-driven requirements that are superimposed on a portfolio. Many of these may be ethically driven, weeding out "bad" companies to create a "good" portfolio from a perceived moral standpoint.

Other criteria may simply be products or activities that investors want to avoid, such as tobacco or weapons manufacturing. Another way that SRI criteria may function is as a ranking system among sectors or asset classes, which would give preference to those assets with a lower carbon footprint, for example. Funds using SRI techniques establish criteria in their investment management agreements, and managers must abide by the requirements specified by the client.

Incorporating ESG risks into investment decisions, on the other hand, requires a fundamental understanding of the key material risks and opportunities that each company or asset brings to the table. These include risks associated with areas such as cybersecurity, supply chain, regulatory changes, and environmental impacts. Ideally, all risks should be examined within the context of the whole and not in a silo. Each company or asset has its own unique and dynamic set of material concerns and opportunities. Understanding them is a critical part of fundamental investing.

ESG factors speak to the degree of quality of an asset. Therefore, an asset manager's job is to understand the risks associated with an investment, to engage — as much as possible — with that asset on risk mitigation, and to vote proxies that reflect how best to manage the risks at hand.

The benefits of ESG investing are multifaceted. First, by integrating ESG considerations on a holistic, fundamental basis, investment managers can better price the asset in which they are investing; this helps avoid overpaying for an investment. Secondly, by understanding the individual material issues of an asset, managers can determine the most appropriate weighting for a particular asset within a portfolio. Thirdly, full integration of ESG into the investment process helps investors better engage with companies on the issues that are most material to them. Finally, ESG integration helps manage the downside risk, or the risk that an asset loses value due to the augmentation of a key material risk to the business.

For fundamental investors focusing on individual company strengths, assessments of material issues can vary greatly even within individual industries. Factors such as board structure and effectiveness, remuneration, cybersecurity, the impact of climate change, labor standards, innovation, and diversity vary in importance, but can all have an impact on risk. Where they have the potential to significantly impact an investment, they should be assessed and discussed with management and boards.

In short, fundamental investing relies on a thorough understanding of the individual, specific issues that potentially threaten or help the investment rationale of each asset in a portfolio. ESG factors play a significant role in understanding these risks. After all, a risk is a risk, no matter how it is labeled.

— Cindy Rose, Head of Responsible Investing — Stewardship

Aberdeen Asset management

compared with 11.6 percent for the non-ESG index.

"Many investors are still looking at screens and traditional social responsibility investing," Rose says. "But the real value comes through ESG integration, which can provide you with a better understanding of the value of the asset and the price you should pay."

Growth segment

"Sustainable investing is one of the fastest-growing segments in finance right now," says Michael Baldinger, Head of Sustainable and Impact Investing, Managing Director, UBS Asset Management. Indeed, the sector almost doubled in size from $14 trillion in 2012 to $22 trillion in 2016.

Geographically, about two-thirds of the demand is coming from Europe, where institutional investors typically ask managers to show how they are integrating ESG across their asset classes, says Baldinger. While the U.S. now lags behind, demand is growing three times as fast as Europe, and within a few years it will likely be the largest market.

Baldinger adds that Japan is the fastest-growing market in Asia, although there is a pickup in China as well.

"Many Chinese companies now have ESG policies and disclose their ESG actions," says Ruby Lv, Marketing Director, SynTao–Sustainability Solutions in Shanghai. "The Hong Kong stock exchange requires listed companies to disclose ESG information.

ESG Investing Finds a Big Home in China

Don't be surprised if the next driver you hail with a smartphone app in Shanghai pulls up in an electric sedan.

Financial support is pouring into Chinese electric car manufacturing, ride-hailing apps, bike-sharing, and other zero-emission ways of getting around thanks to booming investor interest in environmentally sustainable transportation. One result is that drivers-for-hire with electric cars are increasingly common in Shanghai.

Transportation is just one of many sectors now supported by ESG (environmental, social, governance) investors, asset managers, government policymakers, and a wide range of manufacturers and service providers in China. Solar power, elder care, water conservation, and eco-friendly, pre-fabricated buildings are also on the ESG agenda.

By 2020, the government plans to have increased clean energy's contribution to the nationwide energy mix to 15 percent and boost pre-fabricated housing to 20 percent of all new residential construction, according to Kevin E. Lee, Executive Vice Chairman at CMIG, China's first ESG-focused investment group.

China's investment community is clearly on board. ESG and "responsible investing" conferences drew large crowds in recent months in Tianjin, and at a Beijing event sponsored by the Asset Management Association of China.

Meanwhile, the government has been promoting credit instruments called "green bonds" as a right-thing-to-do financing channel for environmentally friendly infrastructure projects, consumer product manufacturing, and power generation.

Not only are green bonds designed to support the nation's fight against air, land, and water pollution by, for example, financing solar power stations, but they're also backing companies whose products and engineering know-how can compete in the global marketplace.

A policy circular released in late 2016 by the government's National Development and Reform Commission (NDRC), on behalf of the Central Committee of the Communist Party of China, put the onus on lower level governments in cities, counties, and provinces to support bond financing for infrastructure projects that protect nature and improve environmental conditions.

Local backing, NDRC said, should come in the form of various types of government support for projects financed with investment bonds.

"Local governments should actively guide social capital to participate in green project construction" through "investment subsidies, subsidy guarantees, bond discounts, fund injections and other means," according to the policy. Building projects pegged as "green" can involve water conservation systems and industrial parks with low-emission power sources.

One example of ESG in action is a solar power and poverty alleviation project in western China's Ningxia Hui Autonomous Region. Farmers who used to eke out a living in a desert are now raising sheep by taking advantage of pasture grass growing amid solar panels at the Ningxia Solar Farm. A CMIG division that's building the solar plant also helped farmers finance sheep-raising businesses.

A recent report by Deloitte predicted Chinese government preferential policies will continue supporting green corporate bonds and similar ESG investment initiatives for the long term. Beijing wants "all types of financial institutions, securities investment funds and other investment products, the Social Security Fund, and corporate pension and social funds" to invest in "green companies, enterprises and other institutional investment bonds," the report said. ●

ESG Leader CMIG Builds Investments on Shared Strength

China Minsheng Investment Group (CMIG) is blazing a trail for ESG investors in the world's second-largest economy. In fact, the Shanghai-based firm with more than USD$45 billion in assets under management was the first investment house in China to build an ESG portfolio.

That was in 2014, when the group was founded by 59 private enterprises with expertise in areas ranging from manufacturing to cold chain logistics, asset management, pharmaceuticals, and e-commerce. Today, CMIG is a parent of a dozen subsidiaries focused on clean energy, green building construction, elder care, insurance, and other sectors.

Since its inception, no single stakeholder has controlled more than 2 percent of CMIG. The firm is all about bringing together private capital to share resources, reduce risk, and facilitate group development. Its vision is to drive China's economic upgrading and transformation by injecting private investment's vitality into traditional industries.

The firm gets strategic advice from a group of prominent leaders and economists who serve on the CMIG Global Advisory Council, including Angus Deaton, 2015 winner of the Nobel Memorial Prize in Economic Sciences; Dominique de Villepin, former prime minister of France; and Goh Chok Tong, former prime minister and now emeritus senior minister of Singapore.

CMIG believes cooperation and sharing leads to strength. Thus, in April, it led a consortium of Asian financial institutions in launching a fund for investment opportunities in ESG areas such as elder care and healthcare, as well as fintech and industries tied to China's Belt and Road global outreach initiative. It has also created a global institutional investor platform with Asian sovereign wealth funds and banks to build a united Asian force for international markets. ●

CMIG's Quest for Responsible Return

An interview with CMIG Executive Vice Chairman Kevin E. Lee

What's the CMIG strategy?
In seeking sustainable, long-term returns, CMIG's investment strategy is guided by two themes: economic transformation areas, such as new energy, infrastructure, and financial services; and consumer areas, such as in-home senior care and healthcare.

Our unique investment approach involves deep participation in targeted industries. Operations teams at each of our subsidiaries improve efficiency, with financial support.

CMIG stakeholders share resources, experience, and wisdom with the goal of win-win investing. We've promoted an "industrial teaming-up model" to support urban development in China's Hainan Province, Guangxi Province, and the city of Wuhan.

What's your take on ESG?
Incorporating ESG issues into the investment process reduces risk, drives performance, and identifies investment opportunities. It can have a positive influence on long-term financial performance.

CMIG New Energy is building the world's largest contiguous solar farm in Ningxia, which gets more sunlight than any other area in China. When finished, it will cover 46 square kilometers, meet the needs of about 2 million families, and address poverty by creating 2,000 jobs.

Investment isn't only about chasing returns; it demands responsibility. Through ESG-based investments, CMIG explores opportunities and incubates businesses so that capital can really benefit society. CMIG will always strive to be a respected, trustworthy investor. That's why at every board meeting we remind ourselves we should never forget the ancient Buddhist concept of the beginner's mind. ●

If a company doesn't do it, it must explain why it chose not to disclose."

Another indicator of global interest in ESG is the growth of the UN Principles of Responsible Investing (PRI), which fosters good governance, integrity, and accountability in the financial markets. In the first quarter of 2017, 79 new investors joined PRI, bringing the total of signatories to 1,600.

There are several reasons for the worldwide growth in demand for ESG strategies, including the desire for greater transparency, says Baldinger. "Institutional investors are looking for ways to understand the inner workings of a company beyond the traditional financial analysis."

In-depth ESG research can identify potential revenue drivers, such as innovation, that may not be immediately obvious on the balance sheet. It can also help investors seeking to mitigate risk, such as disruptions to a supply chain, Baldinger says.

Another reason for growth is the implementation of new sustainability regulations in a growing list of countries. "Examples include France's mandatory reporting of climate risk, which raises the bar for financial institutions," Baldinger says.

In keeping with those regulations, many institutional investors are setting explicit targets for reducing the carbon footprint in their portfolio, or are targeting the overall long-term transition to a low greenhouse gas emissions economy, according to Baldinger

"Long-term sustainability is a big theme for institutions, especially insurance companies and pension funds," he says. "They want to understand how issues like climate change will affect the company's assets in the future. As fossil fuels become more expensive and demand shifts to alternative energy, those trends will impact a company's operations, creating both challenges and opportunities."

Customized solutions

One of the challenges facing investors considering allocations to the ESG sector is the diversity of terms, definitions and meanings. "There are many funds with ESG or SRI in their titles, but none of them are the same," Rose says. A carbon-friendly fund, for instance, will have different characteristics than a no-tobacco fund. In addition, fund managers may use different methodologies for assessing the quality of an ESG investment.

Therefore, an institutional investor needs to drill down to see how an ESG or SRI fund's strategy and underlying assets are aligned with its statement of principles, as well as financial objectives. "One pension fund might be focused primarily on sustainability, while another might prioritize governance issues," Rose says. "That's an important driver in the manager selection process."

Reflecting the wide range of investor interest, understanding and commitment to ESG strategies, asset managers like Aberdeen and UBS offer different types of sustainability solutions. "We integrate material ESG considerations into investment decisions across our four asset classes, taking a risk-based approach when analyzing each investment," Rose says.

> **"ESG integration can provide a better understanding of the value of the asset and the price you should pay."**

UBS is among the asset managers that offer screens, integrated ESG analysis, and customized solutions to institutional clients. That includes innovative sustainable investing products, such as a climate-aware rules-based equities strategy, and an impact methodology for measuring portfolio impact on ESG.

"By committing to offer sustainable investment solutions that deliver strong returns, larger asset managers can play a key role in providing this value proposition to asset owners, thereby helping sustainable investment to become mainstream," says Baldinger.

Best practices

For institutional investors considering ESG strategies, Rose suggests the following best practices:

- Understand your own position with regard to ESG. "Has the investment committee adopted an ESG statement or statement or principles? That is a good first step in the process," she says. "Knowing what ESG means to you is fundamental for making investment decisions."
- Sponsors of defined benefit (DB) and defined contribution (DC) plans should stay in regular contact with their participants and beneficiaries. Use emails, surveys, and conferences to gather information. "Find out if your participants express concerns about certain types of investments, or want to focus on ESG investing," Rose says. "If you make the decision at the board level, without gaining that feedback, you are likely to run into problems."
- Use your statement of principles as the foundation for your manager selection process. "Ask for a robust explanation of how each manager integrates ESG into the offering," she says.
- Ask fund managers for regular updates rather than taking a "hands-off" approach. Frequent communication gives investors a timely opportunity to understand what's happening with the fund, as well as the overall sector.
- Ask how the manager interacts with the assets in the portfolio. "Along with understanding the risks and opportunities, we look at how we can engage with the company," Rose says.

Finally, investors should resist the temptation to simply check a few ESG boxes in selecting a manager. "Avoid things that look like easy remedies," Rose says. "There is nothing easy about this process. It may be fashionable to look at sustainable issues like climate change, but you don't get much information of value without doing the research to understand the manager and the individual assets." — *Richard Westlund*

A new set of eyes: Sustainable investing and the power of transparency

Interview with Michael Baldinger,
UBS Asset Management,
Head of Sustainable and Impact Investing

How do you define sustainable investing?
When we talk about sustainable investing, we generally mean the use of material, non-financial data in the investment analysis process. Today, this is most commonly defined in terms of a set of ESG — or environmental, social, and governance — criteria.

The important thing about ESG is to differentiate it from older approaches, such as socially responsible investing. Those were primarily about excluding certain types of investments from portfolios.

We are talking about a completely new set of investment analysis metrics. I like to call it a “new set of eyes” for investors. I really believe this is a game changer for our industry.

Why is this kind of transparency so important?
Investment analysis has always been about transparency, about understanding the businesses we invest in. But there are other factors that affect performance, as well. These are what ESG addresses.

This is material investment information. Companies that care about sustainable use of resources will be less exposed to shortages. Companies with superior labor practices will have more productive workforces, and be less prone to labor strife. Companies that follow governance best practice will likely be better and more sustainably managed, less prone to corruption. The list goes on.

And there is something deeper at work here, too. We are living in a society of increased transparency on all fronts. One way or another, the customers of the companies we invest in will get the information — both positive and negative — that ESG tracks. This may well affect how they buy.

Why is UBS Asset Management investing so heavily in this area?
First of all, because our clients tell us they want it.

Secondly, because we see this as a business opportunity. It speaks for the power of ESG that UBS is going all in on this as a business.

“Sustainable investing is all about a set of powerful new tools that can improve performance through increased transparency.”

After all, sustainable investing is the fastest growing segment in the investment world per the 2016 Global Sustainable Investment Alliance. Between 2012 and 2016, sustainable assets under management almost doubled, from USD 14 trillion to USD 22 trillion. That’s an annual growth of some 25 percent of assets under management.

From an institutional investor perspective, almost 80 percent of asset owners said they considered ESG criteria to be one of their top five issues when choosing an asset manager.

What does UBS offer in terms of sustainable investing?
Our goal at UBS is to be the world’s leading sustainable investing asset manager; to be ahead of the curve and play a material role in the mainstreaming of this important new approach.

We are integrating ESG into our investment research across the whole bank, adding to our sustainable investment related engagement efforts, and rolling out new products — for example, our new Climate Aware and Impact mandates in the public equity space.

We are also helping clients with our expertise. For example, after the Paris agreement it has become clearer to investors that climate change and the energy transformation can pose a risk to investments. Investors have started to reduce the carbon footprint of their portfolio to reduce their risk exposure. Using the breadth of UBS Asset Management skills and resources, including indexing, quantitative and suitability research, we constructed a rules-based strategy for a large government-sponsored pension fund, which applies positive and negative tilts related to climate change, while aiming to deliver returns broadly in line with the underlying global equity index.

And this is just the beginning. It is our intention to create a comprehensive sustainable investing toolbox that can be used to create powerful, tailored solutions that fully benefit from the kind of transparency I have been talking about. ●