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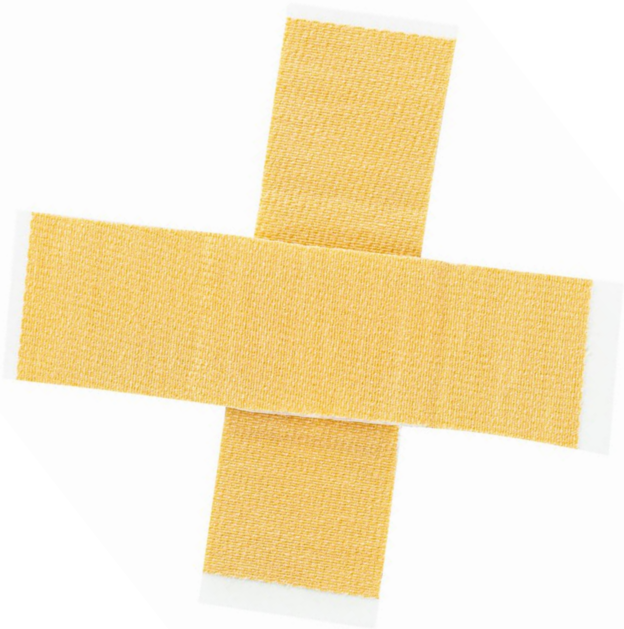
insights



SUSTAINABLE GROWTH

the Recovery Handbook

For investment professionals only
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the editor's word

Somewhere over the rainbow

While the COVID19-led market crash in March sparked hope among sustainable investors, that finally, ESG analysis had proved itself a valuable risk mitigating tool, the benefits during a rebound period are still to be seen.

This unprecedented crisis heavily affected fossil-fuel dependent sectors such as transportation and tourism and for the first time oil price sank into negative territory. While that might well have been a victory for green-hearted investors, it is not necessarily clear that consumers are willingly changing their habits and they might as well resume their uncontrolled shopping and traveling spree when the economy turns back to normal.

With this in mind, what should investors learn from the crisis? How should institutions, who possess a long-term investment horizon, position their portfolios to encourage the right corporate behaviour, while not missing out of the growth rebound?

The pressure on the healthcare and social security systems has also exposed major systemic issues at the same time as social inequalities have continued to expand. However, the pandemic has also revealed the opportunities hiding behind these challenges. According to sustainable investors, the strong performance sustainable investments during the crisis is likely to endure. As our contributors argue, investors who are able to identify the post-Coronavirus winning themes and embrace the new paradigm will be able to make an impact while retaining strong returns.

As the battle against the pandemic is still far from over, the time has come to draw lessons about the past few month, but also to re-calibrate the sustainable investment compass to ensure that, when the time has come, we will not be led astray by the lure of simple profits. There might be a pot of gold at the end of the rainbow but there is also a more sustainable place if we look beyond... somewhere over the rainbow.

Aline Reichenberg Gustafsson, CFA

Editor-in-Chief

NordSIP

“Thanks to digitalisation, Finland, together with the Netherlands, was one of the countries that used remote working the most before the crisis.”

The Unstoppable Momentum of a Sustainable Recovery

The Finn's Way out of a Crisis

by Filipe Albuquerque

Timo Löyttyniemi – CEO of Valtion Eläkerahasto (VER)

Not long after the world started to grasp the true scale of the pandemic’s damage, a consensus started to emerge that the subsequent reconstruction would follow a more sustainable path than the one followed in the past. To understand the post-pandemic paradigm and how it will be more sustainable, we spoke to Timo Löyttyniemi, CEO of Valtion Eläkerahasto (VER), one of the buffer funds supporting Finlands’ pension system.

He argues that the collective participation of politicians, consumers and companies in this sustainable journey has created an unstoppable momentum that will only become more apparent once the recovery begins in earnest.

VER – Mission and Sustainability

“VER was established in 1990 to balance the state’s pension expenditure and invests pension assets to help the state prepare for financing future pensions,” Löyttyniemi says. Although it is similar to the Swedish AP funds, the details of the Finnish pension fund are such that VER is not equivalent to them. “While the Swedish buffer funds exist in parallel to one another to provide portfolio diversification for all of the country’s citizens, the Finnish buffer funds focus on specific segments of the labour force. In Finland, the pension system and benefits are unified. There is one type of benefit structure for all citizens working in the public and private sector. However, the implementation is diversified. VER covers the pensions of public sector employees of the central government. Another pension fund is responsible for municipal workers. Meanwhile, private sector workers are covered by mutual pension funds,” he explains.

“We are a long-term investor bound by an ethical code of conduct,” Löyttyniemi proceeds. “Twenty years ago, when VER began portfolio investments, the focus of our responsible approach to investing was on exclusions, including tobacco, alcohol and

"Balancing the general goals of risk/return and sustainability outcomes is not easy and one can easily veer to one of the two extremes at the detriment of the other."

other industries similarly incompatible with our mandate. Ten years after, we signed the UN Principles of Responsible Investing (PRI). Gradually, we built Environmental, Social and Governance (ESG) capabilities which were integrated into our investment decisions and portfolio analysis. We have also invested in green bonds and ESG funds and have implemented questionnaires that requires existing and prospective asset managers to be aligned with our principles. Among other things, asset managers must be signatories of the UN PRI. Sustainable practices are crucial to VER. Not only do they ensure a future for the next generations, they also create a stable economic environment in which to invest."

The Impact of COVID19

One of the difficulties in establishing a clear narrative of what the post-pandemic recovery will look like is the uncertainty facing institutional investors navigating the turbulent waters of the crisis. "During a crisis such as this, all investors are at the mercy of the market," Löyttyniemi says. "Once the crisis takes hold it's too late to do anything. All that institutional investors can do is hope they have the right asset allocation. It's also difficult to identify the right timing to exit and re-enter the market. Crises in financial markets evolve in stages, but it's difficult to know where we are in that cycle. The worst thing that can happen is that the recession lasts several years. That's what policy makers are trying to avoid through monetary easing and fiscal stimulus."

However, Löyttyniemi admits that Finland appears to have coped relatively well with the pandemic. "Finns were cooperative and followed the rules, which allowed the virus to be contained."

This observation is consistent with data that shows Finland's case-fatality ratio is close to the average for the Nordics. "The selective measures that the government is working on to look for local solutions while avoiding to shut down the country at the same time as managing the risk of a second wave are also commendable."

"Economically, the government has cushioned the blow," he adds. "In part, this is because of the Finnish industrial demand mix which is not so dependent on tourism. Airlines, cruise lines and hotels have been affected as much as anywhere else, but they represent a smaller fraction of the economy in Finland than in other countries." At the time Löyttyniemi notes that Finland started off from an advantageous position. "Thanks to digitalisation, Finland, together with the Netherlands, was one of the countries that used remote working the most before the crisis."

The Economist's Perspective

Nevertheless, economics is not merely a guide to the effects of the pandemic, but also a window to Löyttyniemi's own perspective on sustainable investing, which dates back to 1982. "When I started my studies in economics as an undergraduate, I was intrigued by the issue of pollution and keen to understand it in the context of my discipline. I approached one of my professors to understand what could be done about pollution and was promptly introduced to Erik Dahmén's "Sätt pris på miljön" analysis from the 1960s," Löyttyniemi remembers. "The book introduced me to the management of externalities and the role of policy to force market participants to internalise the costs through taxation and regulation."

"A final decision has not yet been reached, but based on what our peers do and considering what is doable, it seems likely that we will be using carbon intensity as one of the key measures."

"As an economist, these analytical tools remain the core of my understanding of this issue. However, consumer, as complex members of society with political preferences and legal attitudes, cannot be ignored. Intervention has to be consistent and focused on the long term to shift consumer demand towards more desirable goods and services."

COVID19 and Continuity in Sustainable Investments

However, for Löyttyniemi, it is this combination of consistent policy action and shifting consumer preferences that sets the post-Coronavirus recovery apart from the post-subprime recovery. "This crisis is very different from the previous one twelve years ago. Sustainability at the time was at a different stage. At the time, it was a general theme, vague and less crystallised in the public's mind. It was less powerful."

According to Löyttyniemi, in the intervening years, responsible investors and sustainability, in general, have matured. "Nowadays, sustainability has entered our mainstream social and political vocabulary. It is much more powerful as a theme, not only due to people's attitudes and preferences, but perhaps more so because of potential government policies. The key change in the world has been that nearly everyone acknowledges that climate change is a key relevant topic."

"At the same time, balancing the general goals of risk/return and sustainability outcomes is not easy and one can easily veer to one of the two extremes at the detriment of the other. However, when governments take consistent measures to fight climate change, it has a monetary impact on corporations and investors, whose behaviour becomes more concrete, measurable and timely. There was no such consensus within sustainability twelve years ago. While ESG was too incipient to be a driving factor of the previous recovery, the very momentum of sustainability as an investment, societal and policy theme will ensure it dominates the recovery this time around."

Carbon Footprinting

Informed by this realisation, VER will also follow a more "concrete" and "measurable" path along its journey as a sustainable investor, according to Löyttyniemi. "We are now in the midst of adding another layer, to our exclusions, ESG integration and investing," he says. "We are looking at ways to integrate the analysis of carbon footprint into our investment strategy. We are interested in identifying what the appropriate metrics are and set goals based on these metrics and report on our progress."

"A final decision has not yet been reached, but based on what our peers do and considering what is doable, it seems likely that we will be using carbon intensity as one of the key measures," Löyttyniemi adds. "It's not the only measure we are considering, nor is it the best of all measures. But it is among the most relevant, understandable and easily implemented, which is appealing. Carbon intensity can be calculated for indices so it gives us an operative tool to follow."

"As an investor, VER is very much benchmark-driven so this fact is also very appealing. We are working towards an Autumn deadline for identifying these metrics and setting up our goals," he concludes.

Photo by Nick Jackson on Twenty20

Engagement and Investors' Role in a Sustainable Recovery

Putting People at the Heart of the Response to the Pandemic

by Magnus Odén

Our society has progressed away from the idea that a company's only social purpose is to maximise profit. We now have a widely adopted view of a stakeholder economy where the purpose of businesses is to solve problems for the people and the planet, profitably.

Magnus Odén
Head of Norway and Sweden
at the UN PRI

Covid-19 has served as a stark reminder, and the clearest example to date, that without healthy people and a healthy planet we cannot have a healthy economy and a brighter future. Investor engagement and behaviour across a number of areas – including far deeper engagement with policy makers in the Nordics and elsewhere - will play a critical role in determining how the current situation impacts our economies and societies.

To take a step back, our society has progressed away from early 70s Friedman ideas that a company's only social purpose is to maximise profit. We now have a widely adopted view of a stakeholder economy where the purpose of businesses is to solve problems for the people and the planet, profitably. This interdependence has never been more clearly manifested than during the pandemic. The ILO has estimated that over 300 million jobs have been lost [1] and the World Bank estimates that the GDP drop will be the steepest in post-war history [2]. These are costs that ultimately will be paid for by taxes on future economic activities. For any recovery to be sustainable from a financial and social perspective, investor policy engagement needs to be raised sharply.

The impact on business

Businesses have been hard hit and many companies are still fighting for their survival. Construction and travel sectors have suffered severe demand side shocks, manufacturers have been affected by supply side disruptions and all businesses have been affected by the government policy response. Strangled by lack of long-term planning, some businesses have been stuck operating in fading sunset sectors and several have already met an early death. Similarly, in many markets, policymakers have been overwhelmed and came unprepared into the situation. However, furlough schemes, recapitalisations and additional healthcare funding were swiftly introduced in the Nordics and other countries to avert a quick societal

[1] Staff at the ILO, 2020 - https://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/documents/briefingnote/wcms_749399.pdf
[2] Staff at The World Bank Group, 2020 - https://www.worldbank.org/en/publication/global-economic-prospects

"Virtual AGMs are not the ideal format, but retaining the fundamentals of organisational empowerment, responsibilities and exchange of experience has been crucial."

deterioration. Some investors, also challenged by the pandemic's fast-moving implications, were quick to organise immediate crisis plan responses and to identify needs in the portfolio companies.

The Investor Response

In the first phase of the crisis, investors were quick to initiate discussions with the right people in their portfolio companies to draw up plans for guaranteeing the safety of staff and securing financial support. Through their access to industry expertise and the extra time devoted, they have ensured that the discussions included the recovery steps to build back better for the long term. Virtual AGMs are not the ideal format, but retaining the fundamentals of organisational empowerment, responsibilities and exchange of experience has been crucial. It has allowed firms to agree on matters such as official and binding commitments on dividend payment restrictions and executive remuneration during tough times.

Now that we are in the second phase of the crisis, a cleaner, greener and more inclusive outcome is a common goal for investors as a group, but for this to happen, investors must also engage in much deeper and more frequent dialogues with policy makers. It was clear that the response to this crisis could have evolved differently with greater social dialogue and the inclusion of more parties at the negotiating table. Investors with essential access to technical expertise, who can leverage arguments based on this, should engage with policy makers both in private and through media to shape the agenda so that concrete reforms are delivered in this pivotal phase.

Through collaboration with other investors who share the same objectives, speaking up jointly on how policies will affect the investor base in the long run carries much heavier weight and will facilitate the communication with policymakers and advance the agenda.

In Sweden, a key pillar of the recovery package was that furloughed staff would be paid for by taxpayers through the government programme and conditioned on cancelled dividend payments, ratified by parliament with a broad unity across the political spectrum. However, a few large global companies continue to pay dividends, whilst collecting government benefits for their laid off staff. Investor support for the practise and overt criticism towards the conditioned benefit policy is an unnecessary provocation that will subject them to more scrutiny and rejection by their stakeholders: the government, customers, suppliers, staff and taxpayers. Most investors are aware that a cancelled dividend may transform into a larger dividend once we have come out the other end of a recovery, in better shape. A central theme to succeeding in the competitive stakeholder economy is the acknowledgement of interdependence, sharing of common objectives and working in accordance with them.

The Tragedy of the Horizon

Mark Carney has re-labelled the classic problem in environmental economics where our generation imposes a huge cost on future generations because we have no incentive to fix it as 'The Tragedy of the Horizon'[3]. Viewing the Covid-19 crisis through this lens,

[3] Carney, 2015 - https://www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability

investors are currently being presented with an extraordinary opportunity to benefit from government support and investments in helping to cover this cost today. The biggest leap forward that responsible investors can take for their portfolio work today is to link action on climate within their response to the Covid recovery. If done collaboratively with governments, who are spending unprecedented sums of borrowed money to provide relief, the chances of improved prospects rise sharply for all involved and lowers the cost in mitigation and adaptation for the future.

The root cause of the pandemic – transition of virus from animal hosts to humans – is directly linked to the environmental degradation and the loss of biodiversity[4]. Once in the human system, the detrimental effect on health, healthcare costs, job losses and income quickly spiralled out of control. Therefore, environmental priorities need to come first, because investments in the clean energy production and distribution systems and reforestation are necessary to restore biodiversity and clean the air, as well as being able to deliver jobs and replace lost profits.

Putting People at the Heart of the Response

The scale and severity of the crisis has also demonstrated the need to put people at the epicentre of the response. Human rights abuse has been abundant and more so in emerging economies. There, workers often only have informal job arrangements with no notice period or severance packages, no government unemployment benefits and a main earner responsible for feeding a large family. Private investors from the developed world like the Nordics have a responsibility to enforce human rights through their investee companies and their suppliers to secure a fairer and resilient future.

UN Secretary General, António Guterres, said in April that, "People — and their rights — must be front and centre"[5]. Investors should address solutions to social issues such as pushing much further for international tax harmonisation and transparency issues. Investors should also push for improved terms for small businesses, the biggest employee sector in which most are suppliers to large businesses. Investors and policymakers' objectives closely align in these areas.

A Sustainable Recovery?

The money is on the table, but it is not the sustainable and optimal long-term solution. The European parliament has established a gigantic recovery fund, but the necessary investments to reach the committed emission targets are still short and the programme only reserves a limited amount to this end, the German think-tank Agora Energiewende wrote in a recent report 6. Additionally, although tax-payers will think that the short term fical stimulus is proportionate to the crisis, in a longer sustainable scenario, governments will need a credible exit strategy to avoid misallocated resources and excessive risk taking by investors triggering the next financial crisis. Businesses and investors on the other hand have the required expertise, substantial capital and need for profitable investments to shift into these undertakings and ambitions. The International Energy Agency (IEA) together with the International Monetary Fund (IMF) have proposed over 30 concrete actions that boost growth and job creation and push greenhouse gas emissions into structural decline 7. Investors will be rewarded for reminding governments that they stand ready to back initiatives which are scalable, ready to execute and potentially profitable. The task at hand is to enable dialogue with public policy makers and assist with expertise on the next steps into sunrise sectors, replacing lost jobs and design a greener, healthier and inclusive recovery.

The longer-term outcome from the pandemic will be shaped in the coming months as economic activity is gradually coming back. We have been presented an obvious opportunity to accelerate the pressing agenda on climate change which outstrips any other portfolio risk. Emission cuts from aviation, oil and gas need to be the top priority. These industries have been hurt the most, but in the longer term the priorities remain the same. Through collaboration, investors and government can help alleviate the core issues of global recession and soaring unemployment, taking into account the need to innovate and build cleaner and more secure energy systems. Nordic investors responded well during the initial phase of the crisis. Now, at the second phase, engagement and dialogue with policy makers will play a key role and should be very ambitious.

[4] Staff at the PRI, 2020 - https://www.unpri.org/sustainability-issues/environmental-social-and-governance-issues/environmental-issues/biodiversity
[5] Staff at the ILO, 2020 - https://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/documents/briefingnote/wcms_749399.pdf
[6] Staff at The World Bank Group, 2020 - https://www.worldbank.org/en/publication/global-economic-prospects

Photo by Tyssul-Patel on Unsplash

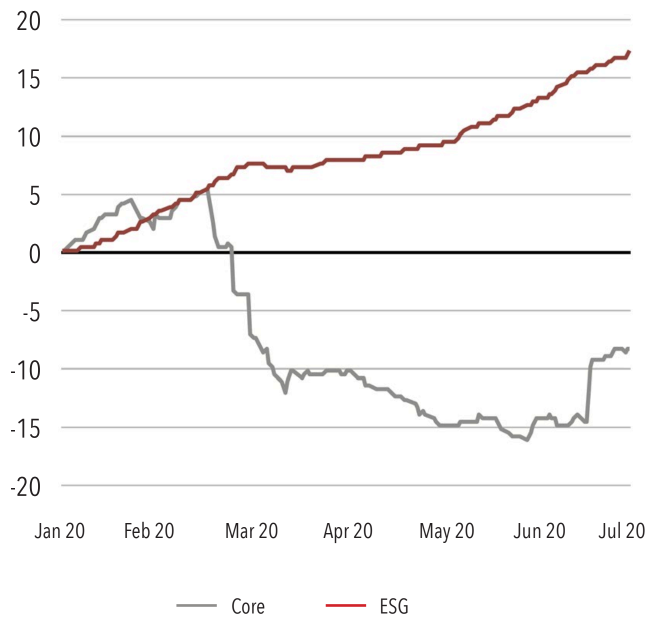
Sustainable ETF Investments in the Post-Pandemic World

by Filipe Albuquerque

Although COVID-19 has changed the face of the global economy and added new levels of volatility to financial markets, we have repeatedly heard from sustainable investors that their strategies have been able to successfully weather the crisis, often even outperforming traditional benchmarks. One market segment where this disparity is evident is in exchange traded funds (ETFs).

In the twelve months to July 2020, the value of sustainable ETFs doubled to US$52 billion thanks to the appeal of ESG strategies during the COVID-19 drawdown. This performance is consistent with the empirical observation that companies with a higher Environmental, Social and Governance (ESG) rating tend to be more resilient and experience lower drawdown during instances of market turbulence. Indeed, data from UBS Asset Management shows that the COVID-19 experience was no exception to this longer-term trend. While investors withdrew from broad equity and fixed income ETFs, ESG ETFs experienced inflows worth US$17 billion in the nine months through to September (Figure 1).

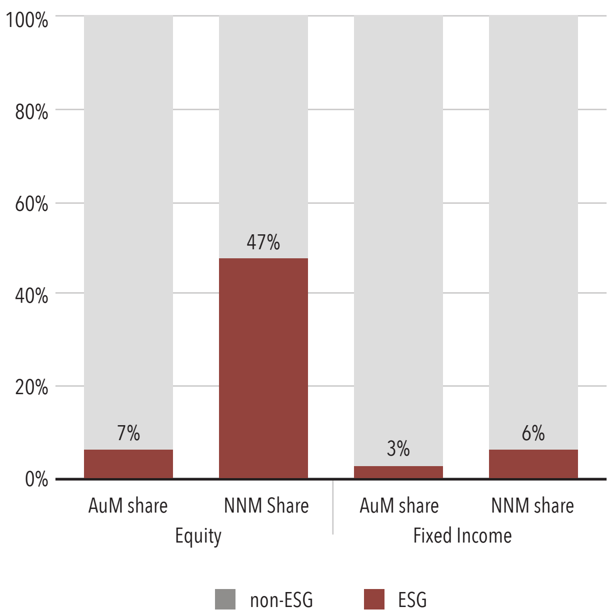
Figure 1. Year to date NNM (USD, billion)



Source: USB Asset Management, Bloomberg.
Data from January 2020 to 31 July 2020.

According to the Swiss asset manager, in the first seven month of 2020, ESG ETFs represented 23% of all net new investment inflows into European ETFs, so that by the end of July European ESG ETFs represented 5% of the share of the whole European ETF market. The rise in the share of new net money flowing into ESG "signals strong growth", according to research by Puri Tarun, Matthias Dettwiler, Christian Kunth, and Marcin Wojtowicz at UBS AM[1].

Figure 2. AuM and NNM ESG share by asset class



Note: Flows in USD, AuM statistics calculated at the end of the period.
Source: USB Asset Management, Bloomberg.
Data from January 2020 to 31 July 2020.

"Breaking down the growth between Equity and Fixed Income ESG solutions, you can observe in figure 2 how, without surprise, this growth is mostly driven by Equity ESG Market which appear to be more mature," the UBS team explains. "In fact, ESG ETFs captured 47% of the inflows into equity ETFs between January 2019 and June 2020, while fixed income ETFs' share was only around 6% during the same period. The adoption of ESG in fixed income is therefore likely to catch up in the near term. With the recent launches, there are now available 32

[1] "UBS ETF On Track Research - Sustainable Fixed Income", September 2020, by Puri Tarun, Portfolio Manager Index FI EM; Matthias Dettwiler, Head Index Fixed Income, Managing Director, UBS AM; Christian Kunth, Product Development Passive, Executive Director, UBS AM; Marcin Wojtowicz PhD, ETF Research & Analytics, UBS AM

"Investors are using their influence to drive behavioural changes, in a sign that shareholder engagement should remain a key component of sustainable investment going forward."

European-listed fixed income ESG ETFs covering main bond sectors such as corporates, sovereigns and emerging markets (30 June 2020, ETFGI)."

Renewed Investor and Policy Support

According to UBS, the Coronavirus epidemic is likely to trigger a paradigm shift in a range of economic practices and sectors, which are supportive of ESG investments, be it healthcare, education, transportation and renewable energy. "Investors are using their influence to drive behavioural changes, in a sign that shareholder engagement should remain a key component of sustainable investment going forward," Rachel Whittaker, Andrew Lee, Michaela Seimen Howat and Antonia Sariyska, from UBS say[2]. Not only have many of the companies in those natural ESG sectors been able to provide solutions to the limitations imposed by the pandemic, they are also likely to benefit from the solutions and rescue packages organised by governments around the world.

Many national governments have answers the April 2020 call of the UN Secretary General António Guterres to focus economic rescue packages on businesses that "steer our world on a more sustainable and inclusive path – a path that tackles climate change, protects the environment, reverses biodiversity loss and ensures the long-term health and security of humankind. By making the transition to low-carbon, climate-resilient growth, we can create a world that is clean, green, safe, just and more prosperous for all."[3]

In the EU, companies rescued by public aid will be barred from paying executive bonuses and aggressive commercial expansion until the aid has been repaid. Moreover, not only have member states endorsed the Green New Deal, they have endorsed a fiscal stimulus package to manage the pandemic. But governance issues have also been highlighted. In Denmark, government bailout programs exclude companies located in tax havens, for example.

Sustainable Fixed Income After COVID19

Fixed income markets offer an appealing channel through which investors can gain exposure to the companies riding the new growth opportunities created by COVID-19. At US$40.9 trillion, corporate bonds represent almost a third of the US$128.4 trillion global bond universe[4]. Asides from the large liquidity of this market, there are several other reasons for the appeal of fixed income as one of the main channels through which investors could gain exposure to new sustainable trends. "Many investors prefer credit over equities, given bond-holders' preferential claim on corporate cash flows in a highly uncertain economic environment. With a vast array of maturities, yields and credit quality available, investing in corporate bonds has the potential to provide higher yields than government bonds as well as providing diversification benefits for investors," Tarun, Dettwiler, Kunth and Wojtowicz explain.

In parallel, the rising popularity of ESG in fixed income seems to also have been reinforced by investors' reaction to the COVID-19 pandemic. Indeed, the strides made during the crisis to use social bonds as a channel for funding coronavirus initiatives signals a growth for this entire segment going forward.

Green bonds and Social bonds are the dominant direct investment opportunities in sustainable fixed income. Since 2014, the total green bond market has risen to over €750 billion and has become a core component of any sustainable investment portfolio. "Demand remains high and green bonds are likely to play a key role in the European Commission's action plan to finance sustainable growth," Whittaker, Lee, Howat and Sariyska say. According to the UBS analysts, the EU green bond standards provides "strong drivers in European green bond markets, but also having a global effect on the quality of green bonds, and influencing advancements with regard to other investment products along the lines of transition, social, and SDG-linked bonds."

Social bonds have traditionally been obscured by the popularity of their green counterpart and the prominence of the climate change concerns they address. However, the rise of COVID-19 fuelled an explosion of social projects and investments which social bonds were tasked with funding. "In April 2020, in the midst of the COVID-19 crisis, issuance of bonds with ESG characteristics increased by 272% y/y, including for the first time, sustainability bond issuance (US$19.4 billion) exceeding green bond issuance (US$16.8 billion) in a single calendar month (according to Morgan Stanley)," Whittaker, Lee, Howat and Sariyska add.

Fixed Income ESG ETFs

For investors unwilling or unable to tap these investment opportunities directly, fixed income ETFs can offer an appealing alternative.

"We have seen strong investor interest with year-to-date inflows of USD 5bn into our ESG ETF range as per end of August. Our offering currently consists of seven fixed income ETFs with ESG screening which provide clients with the opportunity to gain exposure to global sustainable corporates, development bank bonds as well as sustainable Government and emerging market bonds. We are keen to keep developing innovative ESG solutions to best serve our client´s needs. Just this month we have launched the first ever ESG ETF with exposure to European treasuries", says Florian Cisana, Head of Passive and ETF Sales Nordics.

Overview of UBS Sustainable Fixed Income ETFs

ESG ETF	ESG benchmark	Parent benchmark	ESG data provider	ESG screening methodology
UBS ETF – Bloomberg Barclays MSCI Euro Area Liquid Corporates Sustainable UCITS ETF	Bloomberg Barclays MSCI Euro Area Liquid Corporates Sustainable	Bloomberg Barclays MSCI Euro Area Liquid Corporates	MSCI	Medium-green
UBS ETF – Bloomberg Barclays MSCI US Liquid Corporates Sustainable UCITS ETF	Bloomberg Barclays MSCI US Liquid Corporates Sustainable	Bloomberg Barclays MSCI US Liquid Corporates	MSCI	Medium-green
UBS ETF – Sustainable Development Bank Bonds UCITS ETF	Solactive Global Multilateral Development Bank Bond USD 22% Issuer Capped	Duration-matched Treasuries	MDB bonds only	Dark-green, fully sustainable
UBS ETF – J.P. Morgan Global Government ESG Liquid Bond UCITS ETF	J.P. Morgan Global Government ESG Liquid Bond	J.P. Morgan GBI Aggregate	Sustainalytics and Reprisk	Light-green
UBS – J.P. Morgan USD EM IG ESG Diversified Bond UCITS ETF	J.P. Morgan USD EM IG ESG Diversified Bond	EMBIG Div. IG and CEMBI Broad DIV IG	Sustainalytics and Reprisk	Light-green
UBS ETF – Bloomberg Barclays MSCI Global Liquid Corporates Sustainable UCITS ETF	Bloomberg Barclays MSCI Global Liquid Corporates Sustainable Bond	Bloomberg Barclays MSCI Global Liquid Corporates	MSCI	Medium-green

Source: USB Asset Management, July 2020.

[2] "Sustainable investing after COVID-19", 12 May 2020, Chief Investment Office GWM Investment Research, by Rachel Whittaker, CFA, Analyst, UBS Switzerland AG; Andrew Lee, Head Sustainable & Impact Investing, UBS Financial Services Inc. (UBS FS); Michaela Seimen Howat, Analyst; Antonia Sariyska, Analyst, UBS Switzerland AG

[3] "Remarks to Petersberg Climate Dialogue", 28 April 2020, António Guterres: ttps://www.un.org/sg/en/content/sg/speeches/2020-04-28/remarks-petersberg-climate-dialogue

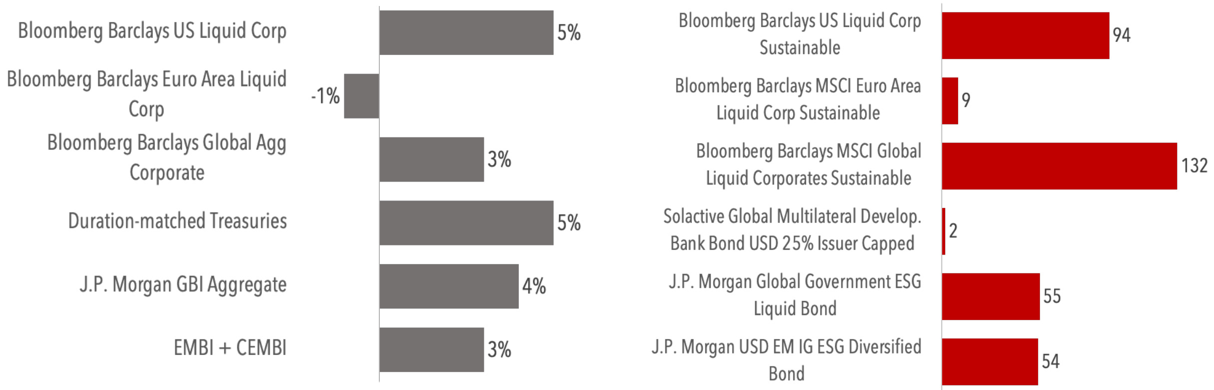
[4] August figures from the International Capital Markets Association (ICMA): https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/bond-market-size/

Sustainable fixed income indices are developed in co-operation with multiple index providers, using data from several ESG rating providers. For example, the largest portion of the UBS ETFs within the fixed income ESG category tracks "Liquid Corporates Sustainable Indices", with exposures to the US Liquid Corporates Sustainable, Euro Area Liquid Corporates Sustainable and Global Liquid Corporates Sustainable indices. The indices are built around a multi-step process starting from an existing corporate benchmark, say the Bloomberg Barclays Global Aggregate Corporates index. The index then undergoes a liquidity filtering as well as ESG screening. Firstly, bond issues based on a variety of liquidity criteria (e.g. time since issuance, amount outstanding) are selected in order to target the most liquid part of the universe. As a consequence, several older short maturity bonds are removed, increasing the duration of the MSCI Global Liquid Corporates Sustainable Index to 8.69. On the resulting portfolio, UBS then applies a three-step ESG screening process. Firstly, bonds with a MSCI ESG Rating below BBB as well as those securities that are unrated from an ESG perspective are excluded. Subsequently, businesses involved in a range of problematic industries (i.e.: Alcohol, Tobacco, Gambling, Adult Entertainment, Genetically Modified Organisms (GMOs), Nuclear Power, Civilian Firearms, Military Weapons) are also excluded. The final exclusion consists of companies which are red-flagged by the MSCI ESG Controversies Score as well as those that do not adhere to international norms.

Performance of selected indices in H1 2020 (incl. COVID-19 period)

Total return on standard indices
Period: 31 Dec 2019-30 Jun 2020 (in %)

Excess return of ESG indices vs. Standard benchmarks
Period: 31 Dec 2019 - 30 Jun 2020 (in bps)

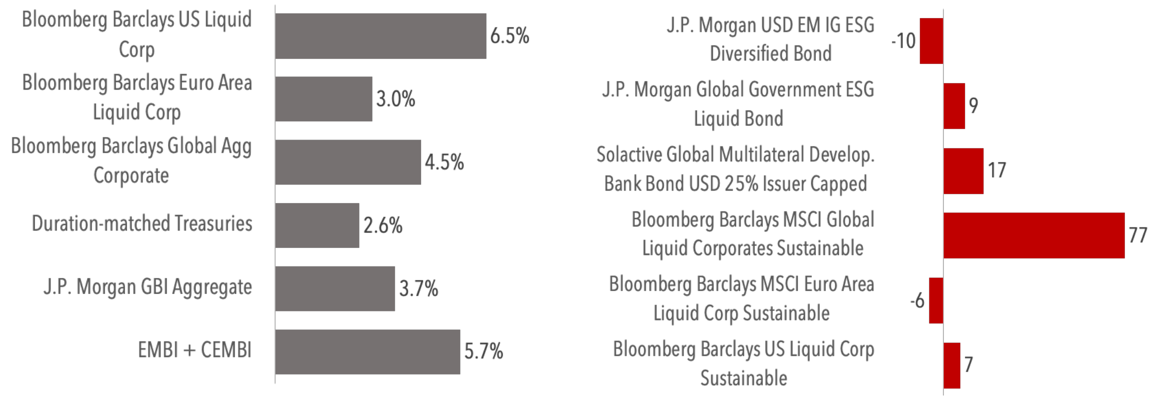


Source: Bloomberg Barclays, USB Asset Management. Data as of 30 June 2020.

Performance of selected indices over 5Y period

Total 5Y annualized returns on standard indices
Period: 30 June 2015 - 30 June 2020 (in %)

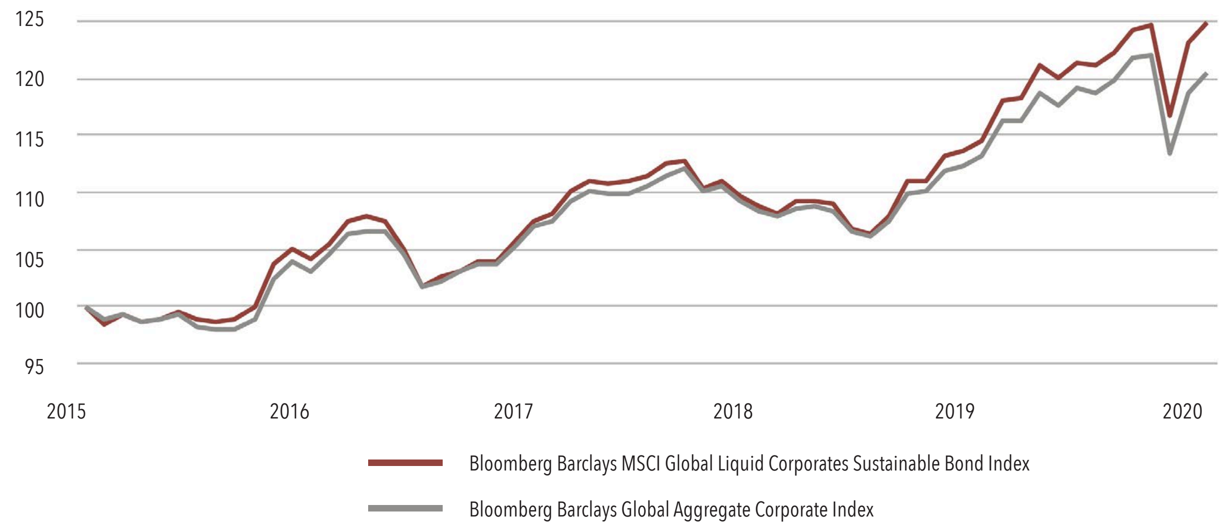
Excess annualized 5Y returns of ESG indices vs. Standard benchm.
Period: 30 June 2015 - 30 June 2020 (in bps)



Source: Bloomberg Barclays, USB Asset Management. Data as of 30 June 2020.

Florian Cisana, Head of Passive and ETF Sales Nordics, UBS ETF

Performance



Source: USB Asset Management, July 2020.

Typically, ESG versions of standard indices exhibit limited tracking errors versus their parent benchmarks and are considered as a suitable replacement for the core allocation to these exposures. The performance figures suggest that sustainability does not hinder financial objectives, but has a complementary effect. For the selected benchmarks, UBS finds that the sustainable portfolios perform at least as well as the standard benchmarks within fixed income.

For example, the Bloomberg Barclays MSCI Global Liquid Corporates Sustainable Index has delivered a return of 6.04% per annum in the period from 31 July 2015 to 31 July 2020 which equals an annual outperformance of 0.77% versus the standard index.

According to the Swiss bank, these insights support the hypothesis that an ESG focus can be seen as a competitive advantage, which may allow companies to deliver better long-term value to investors.

"There is widespread consensus that we need to do better than returning to "business as usual" after the pandemic – we need to build back better"

Torben Möger Pedersen – CEO of PensionDanmark

Opening Opportunities for Impact

Sustainable investments during the COVID-19 pandemic

by Filipe Albuquerque

Sustainable investment and impact during the COVID-19 pandemic

While the economic and financial crises triggered by the global COVID-19 pandemic have raised profound challenges to the economic systems that we all navigate, committed investors are also able to uncover investment opportunities. As the crisis accelerates an ongoing paradigm shift, Torben Möger Pedersen, CEO of PensionDanmark, tells NordSIP about the Danish pension fund's commitment to impact investing the SDGs and how it has been able to satisfy demand from long term investors and find above average returns.

The Resilience and Impact Consensus

According to the CEO, the clear lesson taught by the pandemic is that we need to build a more sustainable and resilient society. "Most government's first priorities in managing the COVID-19 pandemic was (and still is) to respond to and overcome the health emergency and the resulting economic crisis. Thus, more responsibility of securing green transition now lies on the shoulders of private investors. There is widespread consensus that we need to do better than returning to "business as usual" after the pandemic – we need to build back better," Pedersen says.

"We need to build resilience into our systems against future shocks by making our societies fairer and by ensuring global temperature rise below 1.5°C above pre-industrial levels," he argues, adding that sustainability is a crucial issue in the public and corporate spheres. Sustainable measures that change both corporate strategies and public lifestyles are being introduced at an increasing speed, Pedersen explains. "However, such measures cannot happen without significant investment. Preparation for future crisis is costly, but it will be worth it, as dealing with the crisis will be much more costly if it actually hit."

Langelinie Alle 43

Since the previous crisis, the need for impact seems to have been embraced by investors as well. "The financial crisis during the COVID-19 pandemic is very different from previous crisis. Had this crisis followed the same path as in 2008, sustainable stocks would have taken a hit due to the general market crash and the collapse of traditional energy prices. However, when looking at PensionDanmark's portfolios there is a clear pattern for sustainable and 'long termish' assets to outperform more traditional assets during the Coronavirus crisis."

"Asset owners continued to demand sustainable funds during the downturn of the COVID-19 pandemic. Sustainability is no longer seen as a luxury that can only be afforded during a market with rising prices, which testifies to the increasing focus on ESG in recent years. One can say that the sustainable philosophy has passed its test during the Corona Crisis."

"In PensionDanmark, we are actively seeking to make investments with the intention to generate measurable and either environmental or social beneficial impact, alongside a financial return."

Impact Along the UN SDGs

"Doing good and doing well – that is the key tenet of PensionDanmark, which is reflected in all our activities. We are currently in the age of impact investing," Pedersen says, pointing towards PensionDanmark's own activities. "Companies or projects that can bring added value or progress towards the UN Sustainable Development Goals (SDGs) will likely generate above medium return to the investors."

"The SDGs should be viewed as a catalogue of business opportunities and the future belongs to those who understands this. It also means the measures of impact will be more crucial than ever, which is also a focal point in PensionDanmark. Before the crisis hit, progress had already been made, especially on the green bond market and now the EU taxonomy presents new ways of monitoring transition and progress towards a green economy. But much more is needed, specifically to demonstrate social progress and combatting poverty in developing countries."

"Responsibility and sustainability are part of PensionDanmark's DNA," Pedersen says before explaining the relevance of the UN SDGs. "The 17 SDGs have provided us with a framework for our sustainability efforts. They are an integral part of our investment policy, which has won us the position as a global leader when it comes to investments in sustainable real estate and renewable energy infrastructure."

"When we invest in real estate, we create jobs for our members during the construction period and deliver healthy workplaces for the many employees working in our office buildings, hotels and department stores. Investments in wind farms and solar power plants produce green energy and create jobs in Danish companies and their subcontractors. Our results over the past few years testify to the fact that commitment to sustainable investments generates attractive returns while at the same time helps to make the world a better place."

Opportunities and Market Returns

"The starting point for companies and investors is to focus on the core business and assess where and how it is possible to contribute to the SDGs, while not losing track of leading or prospective companies in the class and checking the valuation and upside potential. Some clear examples from the stock market includes Vestas and Orsted, but many opportunities will be found in the unlisted universe. Small and medium enterprises (SMEs) with smart tech solutions or developers of sustainable buildings are particularly appealing," the CEO explains.

The success of sustainable strategies is neither anecdotal nor incidental. It is backed by PensionDanmark's statistics, according to Pedersen. "When looking at PensionDanmark's portfolios there is a clear tendency for sustainable and 'long termish' investment to outperform more traditional assets during the crisis." According to the Danish pension fund's experience during the second quarter of 2020, the internally managed sustainable stocks have outperformed the MSCI ACWI benchmark by 1.8 percentage points. The shadow portfolio that PensionDanmark has bought in the Baillie Gifford Positive Change fund, which is a more concentrated portfolio (eg. Tesla weighs in heavy), have outperformed the benchmark by a stunning 18.2 percentage points.

Lessons from Sustainable Real Estate

"The use of the SDGs as a framework for sustainable investments can easily be adapted to different sectors and geographies. In recent years, PensionDanmark has significantly increased investments in real estate where sustainability is the strategic cornerstone. The portfolio consists of business and residential properties as well as Public Private Partnership construction projects," Pedersen explains.

"As a developer and a responsible investor, we emphasize environmental, social and financial sustainability. Sustainable real estate is attractive to owners and tenants by virtue of its low heat consumption and low maintenance costs, which makes it a sound investment that contributes to generating solid returns for our members. Our 292,600 sqm sustainable real estate investments are environmentally friendly as well as profitable by virtue of the materials used, low maintenance costs and low energy consumption. However, there are more benefits of sustainable real estate including good indoor heat management, social spaces for good neighborliness and housing designed for the needs of special groups such as with student housing."

"PensionDanmark strives to combine strong profitability with responsible development, construction and management of our property projects," he says. "Over the past three years, PensionDanmark has worked to develop a sustainability program that now covers the certification of residential buildings, offices, urban open spaces, recreational areas and most recently urban development."

Nerves of Steel and Investment Foresight

According to Pedersen, it is easier to navigate the turmoil of a crisis such as COVID-19 when investors are well positioned for the long term. "In the wake of the crisis there was some overreaction and sell-offs from the parts of the global investor community, which opened the window for some attractive acquisitions. But more importantly our strong exposure to renewable energy infrastructure and sustainable buildings together with a defensive/sustainable tilt in our equity portfolios have made it possible for us to achieve satisfying results."

"YTD, gains and losses from all the asset classes tend to cancel each other out so we are operating without negative returns overall. Hopefully, we can achieve a positive - albeit low - investment result for 2020 as a hole," Pedersen concludes.

Selected Equity Portfolio Returns of PensionDanmark for Q2 2020

	Market Cap (DKK bn)	Return (%)	Benchmark MSCI ACWI (%)	Relative performance
PD Sustainable stocks	5.9	21.2	19.4	1.8
Baillie Gifford Positive Change[1]	2.2	37.6	19.4	18.2
Equity portfolio	55.3	19.1		

Source: Pension Danmark:

[1]Baillie Gifford Positive Change is added to the table as it is a relevant strategy for PD Sustainable stocks to compare against. However, where Ballie Gifford is very focused, PD Sustainable is more dispersed.

Evidence and Ambition: The New Rules of Engagement on Climate Change

by Mirza Baig

Photo by Patrick Hendry on Unsplash

Mirza Baig explains why far-off commitments on climate change by energy companies and their lenders are no longer enough, and why COVID-19 has catalysed rather than derailed investor engagement on the issue.

Mirza Baig
Global Head of Governance
Aviva Investors

This was supposed to be the year when climate change dominated the political and business agenda; with all roads leading to the COP26 summit in Glasgow in November. After the previous climate summit in Madrid proved a huge anti-climax, it was hoped COP26 would get the world back on track towards meeting the commitments of the 2015 Paris Agreement.

But while that event has been put on hold until November 2021, suggestions that climate change has been demoted down the list of investor priorities couldn't be further from the truth.

In the first of a two-part interview, Mirza Baig, global head of governance at Aviva Investors, discusses why engagement has never been more crucial on climate change, with the convergence of global investor interests in stark contrast to the growing disconnect amongst big energy companies. He also highlights why creditors need to seize their opportunity to play a more meaningful role alongside shareholders in affecting change.

How is your engagement with companies evolving on climate change?

We made a conscious decision at the start of the year to accelerate our climate engagement, with more focus on capital allocation and evidencing of companies' transition. A few years ago, the challenge was to get climate on a board's agenda and get companies to a point where they would make transformational commitments in line with the Paris Agreement. Those commitments tended to be very long term, focused on the adoption of 2050 net-zero goals, with 2030 and 2040 milestones along the way.

As part of this year's engagement priorities, we wanted to break this down into tangible near-term targets, metrics, and proof points, so that companies can demonstrate they are acting on their ambition now. Our engagement programme was broadened to include the equity and credit teams, ensuring climate change became a core part of every company dialogue – not just with chairmen and non-executive directors, but also the CEOs and CFOs, who typically focus more on capital allocation and long-term investment.

Are any companies changing their approach as a result?

Traditionally, the focus has been on the biggest direct emitters – oil and gas companies, the extractive sector more broadly, and utilities. Now, we've seen an acknowledgement of the important role of financial services in funding the energy transition.

Take Barclays. Late last year, a shareholder resolution was put forward for the Barclays AGM (which happened in May) to encourage the company to embrace the climate agenda, rather than continue to be perceived as a European laggard. The proposal focused on lending to high-impact sectors. Barclays was initially hesitant because, although listed in the UK, it has a big US presence, and views on climate change among its clients are more "diverse".

Barclays started a dialogue with the investment community, and we were a prominent voice in that process. We met the chairman and senior representatives of Barclays several times over a concentrated period and argued this was an opportunity for the bank to grab hold of the climate agenda and set a standard for others to follow. We were pleased that Barclays ultimately embraced the spirit of the proposal and even went beyond the letter of the resolution, by committing to transitioning its entire lending book to net zero by 2050.

Was this a collaborative engagement with other investors?

It was a multi-stakeholder effort. ShareAction and progressive asset owners can take credit for helping to catalyse the conversation. But we were one of the first stakeholders Barclays engaged with and had a significant influence in pushing it to go beyond the 'asks' of the resolution.

There are other examples. In 2019, we were one of three co-filers of an extensive shareholder proposal at BP. After much discussion with the company, BP backed the proposal and investors gave it over 99 per cent support at the AGM, providing a clear mandate from the market to act. Subsequently, we have had extensive conversations with the chairman, as well as the new CEO Bernard Looney, which culminated in the landmark announcement in February when BP became one of the first oil majors to commit to net zero for its own operations by 2050.

One aspect of BP's pledge of particular importance to investors related to scope 3 emissions. This is a big issue as some 85 per cent of the lifecycle of emissions of the oil and gas sector is attributed to the point of use by customers.

Only 18 months ago, BP said it was unreasonable to expect the sector to take responsibility for its customers emissions. However, fast forward to today, and BP has embraced ownership of its Scope 3 impacts and committed to setting an array of life cycle emissions targets.

These are significant milestones but there is still a lot of work to do. We will continue to exert all of our influence to push for change but are under no illusions that the magnitude of the task ahead will not be achieved without a genuine and concerted multi-stakeholder effort.

Is our voting approach also changing?

People tend to have a binary view towards whether to back a company or climate shareholder proposal – creating a false dichotomy for shareholders to choose between supporting management or the climate. We have created a more nuanced framework to evaluate the extent to which a company is moving forward constructively and at pace, or conversely being obstructive. In the latter case, we will use our vote as a catalyst for change.

We have developed a five-point framework based around key questions:

1. Has the company set a climate ambition and strategy aligned to Paris, in particular a 1.5-degree temperature rise target?
2. Has the company outlined a credible pathway and roadmap to reach net zero by 2050?
3. Can the company evidence near-term adjustments in its capex and operations that would demonstrate its conviction and willingness to change now?
4. What is the culture of engagement like with primary stakeholders, specifically shareholders? Is dialogue constructive or obstructive?
5. What signal will a vote on a director or a shareholder proposal send to the company? Will it support or hinder change?

This balanced framework is important in driving the right outcomes. Again, Barclays is a good example. It has gone a long way towards developing a bold ambition. While the pledge is still light on details, a commitment to provide more colour by the end of this year is reasonable. Recognising the pace of change and the constructive and candid nature of the dialogue, we supported the company and abstained on the shareholder proposal.

The situation was different with Shell. It has spent three years outlining a progressive climate ambition but was unable to move beyond anecdotal evidence of how the business was practically changing in the near term. When it came to capex allocation, the €1bn-€2bn of new energy capex was dwarfed by the €20bn going into 'old energy' assets. As a result, we supported the shareholder proposal as a signal to leadership that it needs to increase the pace of change.

We also supported the climate shareholder proposal at Total reflecting concerns over the nature and timing of engagement with shareholders. Meanwhile, Exxon took the extreme position of blocking the inclusion of a climate shareholder proposal on the ballot [a decision approved by the Securities and Exchange Commission]. As a result, we voted against every single standing director that was culpable in the decision.

"Companies that do not adapt will not survive. If we do not believe companies are prepared and committed to change in a reasonable timeframe, the investment case will be broken, and we will begin moving capital away."

Should investors be more punitive with laggards, perhaps divesting sooner?

It is the age-old argument between staying engaged and divestment: there is no one-size-fits-all answer but in principle we consider it somewhat of a blunt instrument. There are two reasons for this. Firstly, there is not the critical mass in the market for divestment to be a meaningful tool for change – there are always a queue of other investors ready to take your place should you decide to sell.

The other, and potentially more significant, issue is that while divestment sends a signal of dissatisfaction to a company, it does not allow for a clear communication of a desired future state and expected roadmap for change. We prefer to stay invested, stay engaged, and partner with companies as they develop a transition strategy, allowing us to continue to influence the direction and the pace of travel as well as the pace.

Ultimately, though, climate change presents fundamental risks to the long-term viability of a business. Companies that do not adapt will not survive. If we do not believe companies are prepared and committed to change in a reasonable timeframe, the investment case will be broken, and we will begin moving capital away.

There is a perception less scrupulous investors step in when responsible long-term investors divest: is that perception outdated?

There is some truth to it, but there is a narrowing of investor expectations globally. We are a diverse group with varying views on companies. There will never be a homogenous capital market and we wouldn't want that. But even though there is a growing gap and divergence between practices at the corporate level, especially between European and US oil and gas companies, the gap among investors on climate change is closing. No longer can you say: 'European investors care about this, while US funds will go and buy anything'.

There was a significant shareholder revolt at Exxon's AGM; nearly a third of shareholders voted against senior executives as a protest against their climate stance. At Chevron, the majority of investors supported a shareholder proposal to improve transparency over climate lobbying: that was unprecedented. We are seeing similar trends taking place in Australia.

We will soon get to a tipping point where non-responsive companies will find a dwindling set of investors prepared to stick by them, as we have already witnessed in the US coal sector.

Are creditors doing enough?

We have an integrated ESG research and engagement approach across our credit portfolios, which mirrors our equities framework. However, if you look at the market more broadly, there is considerable scope for improvement.

The whole notion of company engagement came from the equity part of the balance sheet because it was rooted in voting activity and the rights and responsibilities of shareholders.

But there is a growing recognition of two things. Firstly, creditors equally have an economic stake in the long-term sustainability of a business; and that ESG factors are a central determinant in the success and failure of companies.

There is also greater acknowledgement of the influence creditors can have. More companies are tapping the bond market rather than the equity market for future funding. The availability of long-term, stable sources of credit is critical to most companies' business plans. At the point of issuance, companies need to make creditors comfortable with their financial health and prospects, and they also need to keep creditors onside for servicing and refinancing that debt. So, there is ample opportunity and leverage for creditors to participate in ESG engagement with issuers that has not happened enough to date.

Given this is a borrower's market, can't companies just ignore investors' demands on ESG, such as climate covenants?

The conversation goes beyond green covenants. Issuing any kind of debt involves providing assurances on the long-term viability of the business. Companies operating in sectors tied to the old economy, such as energy and utilities, that issue 10-year bonds with no clear pathway to transition, are coming to the market with a cloud over future cash flows. That will ultimately impact their credit rating and borrowing costs.

Will the conventional bond market adopt ESG more seriously?

Major credit ratings agencies have improved their capabilities in recent years, establishing research teams and methodologies to rate issuers' ESG credentials, especially their climate credentials. But to date, outside the likes of utilities, we have not seen clear interconnectivity between the ESG/climate rating and the core credit rating of an entity. We need those two methodologies to become more integrated, and for ESG factors to be a more prominent part of an issuers primary credit rating. We are starting to see regulators take action to address this, particularly in the European Union under the sustainable finance action plan, which we are proud to have been involved in shaping.

Is climate change being overlooked given the focus on COVID-19?

I have seen little evidence of that. If anything, COVID-19 has emboldened and catalysed discussions rather than derailed them. Conversations have intensified because there is a greater realisation of the impacts of systemic risks, and the importance of acting early and decisively, before it is too late.

What about at the policy level? Was the postponement of COP-26 a setback?

The postponement was understandable, but frustrating. This year marks five years since Paris, and we expected to see revisions made to nationally determined contributions (NDCs) by individual countries. We know the NDCs submitted to date are more aligned to three degrees than two, so it is disappointing revisions will be postponed.

There are big issues that need to be debated properly; for example, the rulebook for holding countries accountable for their targets, the development of carbon markets, and on ensuring a just energy transition, whereby developed markets help fund and support emerging markets through the transition.

The issues must be resolved to accelerate the commitments companies are willing to make. While some of the big oil majors have outlined bold ambitions, they always caveat this by saying the speed of change will be in line with society – in other words, aligned with government policy. We need governments to move to see widespread transformational changes at a company level.

Read more about Aviva Investor's engagement activity:

"Our research shows that Scandinavia faces a number of climate-related challenges, including a reduction of up to 20% in solar irradiation due to snow melt, which will have potential implications for the region's energy density, methane emissions and infrastructure."

Wendy Cromwell, CFA
Vice Chair and Director of
Sustainable Investment
Wellington Management

Climate change

The next global sytemic risk

by Wendy Cromwell, CFA

The COVID-19 pandemic has provided a painful reminder of the consequences global systemic risks can have on companies, economies and society. While we are living through history, my colleagues and I also have our eyes firmly on the future.

Looking ahead, I see climate change as another systemic risk which will impact the world sooner and more profoundly than many investors believe. Currently, most are aware of climate change and many are focused on mitigating the transition risks from changes in regulation and policy, including strategies to reduce greenhouse gas emissions. But few are fully aware of the physical climate risks that will occur even within the next decade, regardless of society's efforts to mitigate transition risks. Nor are they aware of the implications these physical risks are likely to have on capital markets and asset prices.

One of the problems is that, although climate science and finance have many similarities as disciplines — for example, both are deeply analytical — the knowledge gap between the two is surprisingly wide. Investors study capital markets and focus on issues such as macroeconomics and valuations of individual securities, whereas climate scientists understand

Photo by merrymirta on Twenty20

representative concentration pathways and climate models.

Bridging the knowledge gap

To integrate these two separate disciplines, we launched a groundbreaking research partnership in 2018 with Woodwell Climate Research Center, one of the world's leading climate science institutes, which was until recently known as Woods Hole Research Center. The partnership was originally formed with the California Public Employees' Retirement Scheme (CalPERS), and Ontario Teachers' Pension Plan joined the initiative earlier this year. The partnership's aim was to gain a deeper, fact-based understanding of physical climate risks which would inform our investment processes and thus improve portfolio outcomes for our clients.

By bringing these two disciplines together, this unique partnership has resulted in some powerful synergies and insights far sooner than we had imagined. For me, one key early lesson was that greenhouse gas emissions have a long half-life: their consequences remain long after they are first emitted. Even if all emissions were to cease today, many of the physical climate risks the world will experience over the next 10 – 15 years would still be unavoidable.

Mapping physical climate risks

One of the key outputs so far from our climate research partnership is a series of maps which show projected climate outcomes compared with our reference period of 1950 – 1980, which are then overlaid with capital markets data. This helps us to visualise and quantify where the effects of climate change will be most severe and to understand which companies and issuers will be more — or less — affected. We can then use this information to invest accordingly to help us meet the objectives of our clients and their beneficiaries. The maps focus on six key climate factors: heat; drought; access to water; flooding; hurricanes; and wildfires. They reveal that the near-term risks are more consequential than we expected.

For example, our research shows that Scandinavia faces a number of climate-related challenges, including a reduction of up to 20% in solar irradiation due to snow melt, which will have potential implications for the region's energy density, methane emissions and infrastructure. Many warmer climates face even greater challenges. Within Europe, the Iberian Peninsula is likely to experience 10 to 12 additional three-month droughts over the next decade, according to Woodwell. That will have implications for a wide range of businesses. For example, hydroelectric plants on the peninsula are expected to generate far less electricity. As a result, some far-sighted local utility companies have been divesting their hydroelectric assets and shifting towards other renewables, notably solar.

We have also learnt that some regions of the world face a worrying combination of climate risks. For example, Woodwell projects that, from 2020 to 2029, India will see three additional months of dangerous — or extremely dangerous — days of heat compared with the 1950 – 1980 reference period. At the same time, it will face severe water scarcity issues, compounding the problem. Our analysis also indicates that Houston in Texas is likely to experience two additional months of dangerous or extremely dangerous heat days annually over the 2020 – 2029 period compared with our reference period of 1950 – 1980. Unfortunately, Houston also faces increased hurricane and flooding frequency. However, this does not seem to be reflected in the pricing of many local municipal bonds relative to those of towns and cities elsewhere in the US which don't appear to face similar climate risks.

According to our research, some of the world's most important agricultural regions will contend with multiple climate risks sooner than previously believed. The economic and investment implications of these types of risks are substantial, but our analysis indicates that markets are not yet repricing them. We believe that, when policymakers, market participants and the public eventually come to understand the cumulative risks of climate change, many assets will be repriced — in some cases, dramatically. We believe it is important for active managers not only to seek to mitigate the adverse effects of such repricing on clients' portfolios but also to take advantage of any mispriced opportunities where there is the potential to generate long-term outperformance.

Engaging to drive climate preparedness

We also seek to discover whether companies and issuers are informed about the risks they face and how they are addressing them. Unfortunately, it turns out that many haven't previously been exposed to this type of analysis, and they rarely have a proactive approach. To assess their awareness, we scan publicly available information like transcripts of earnings calls and CDP (Carbon Disclosure Project) reports to see if a company has highlighted a physical risk.

This work has also started to inform our engagements with companies and issuers. We listen and ask questions, share the maps we have developed and help them to think through how the physical risks of climate change may impact their business.

In many engagements, we also share a consultation document we developed with CalPERS. Our "Physical Risks of Climate Change (P-ROCC): a new framework for corporate disclosures" is designed to help companies integrate climate-risk scenarios into their strategic planning. The early response to our climate research and engagement focus has been positive. This has reinforced our belief that further work in this area can prove beneficial for our clients, portfolio companies, partners and industry peers. We are also committed to engaging with the companies and issuers we invest in, helping them to build their resiliency to climate risks and to communicate their approach to climate preparedness.

Putting theory into practice

While the work of our climate partnership is available to all of Wellington's portfolio managers, some approaches lean on it particularly heavily. One such approach is the Wellington Climate Strategy, which was launched in 2007. This fundamental, bottom-up approach aims to deliver a "double bottom line" of strong investment returns and good sustainability outcomes. It invests in companies focused on providing products or services that seek either to mitigate climate change or to adapt to it. The team sub-divides these companies, which span a broad range of industries globally, into five categories: low-carbon electricity; low-carbon transport; water and resources management; energy efficiency/management; and climate-resilient infrastructure. Security selection is based mainly on in-depth fundamental analysis of each company, and allocations to various sectors and themes are continually reviewed to ensure they are consistent with the team's top-down views.

Conclusion

The main objective of our work integrating climate-science data and capital markets data is to achieve better long-term investment outcomes for our clients. However, we also believe that, as society adapts to and mitigates the physical effects of climate change, we will be better able to safeguard our environments for future generations. We hope to play a role in that most important outcome as well.

For more information please visit www.wellingtonfunds.com/climate-change or contact:

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about our partners

Aviva Investors is a global asset manager with expertise across all major asset classes. With €390bn assets under management* across fixed income, equites, real assets and multi-assets spanning 14 countries, employing 1500+* people, clients can benefit not just from our significant local knowledge and experience, but also from the extensive global investment resources at our disposal.

Our commitment to responsible investment is fundamental to our goal of delivering the specific and meaningful outcomes that matter most to today's investor. To do so, we focus on investment integration, active stewardship and market reform.

You can trust that for us sustainability isn't just a fad. It's something we've been doing for decades. As far back as the 1970s we were holding companies to account by voting at their annual meetings.

For us, responsible investment is a way to get the best possible return for you in the long term. We've always believed that companies that conduct their business in a responsible and sustainable way are more likely to succeed over time, benefiting both you and society. Bad practices don't just hit the headlines, they hit the bottom line as well.

*as at 30 June 2020.

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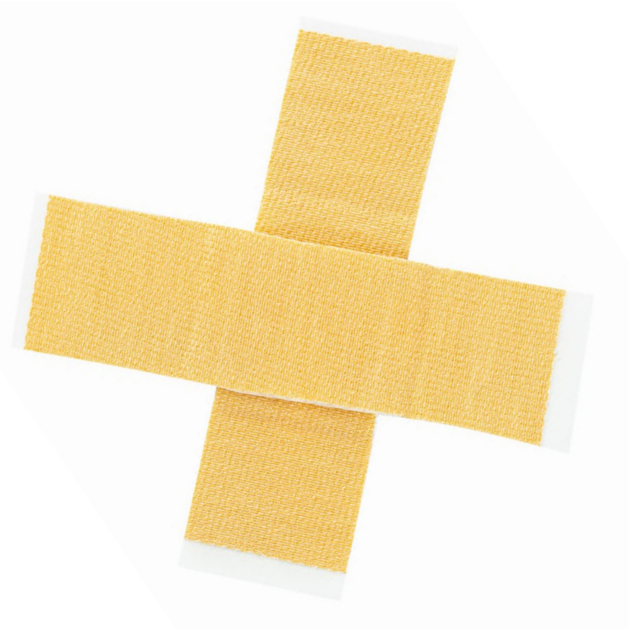
Tracing our history to 1928, Wellington is one of the world's largest independent investment management firms. With approximately US$1 trillion in assets under management as of 31 March 2020, we serve as a trusted investment adviser to a diverse client base of more than 2,200 institutions, insurers, global wealth managers and mutual fund sponsors in over 60 countries. Our comprehensive investment capabilities are built on the strength of rigorous, proprietary research and span nearly all segments of the global capital markets, including equity, fixed income, multi-asset and alternative strategies. As a private partnership whose sole business is investment management, our long-term views and interests are aligned with those of our clients.



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