Medium

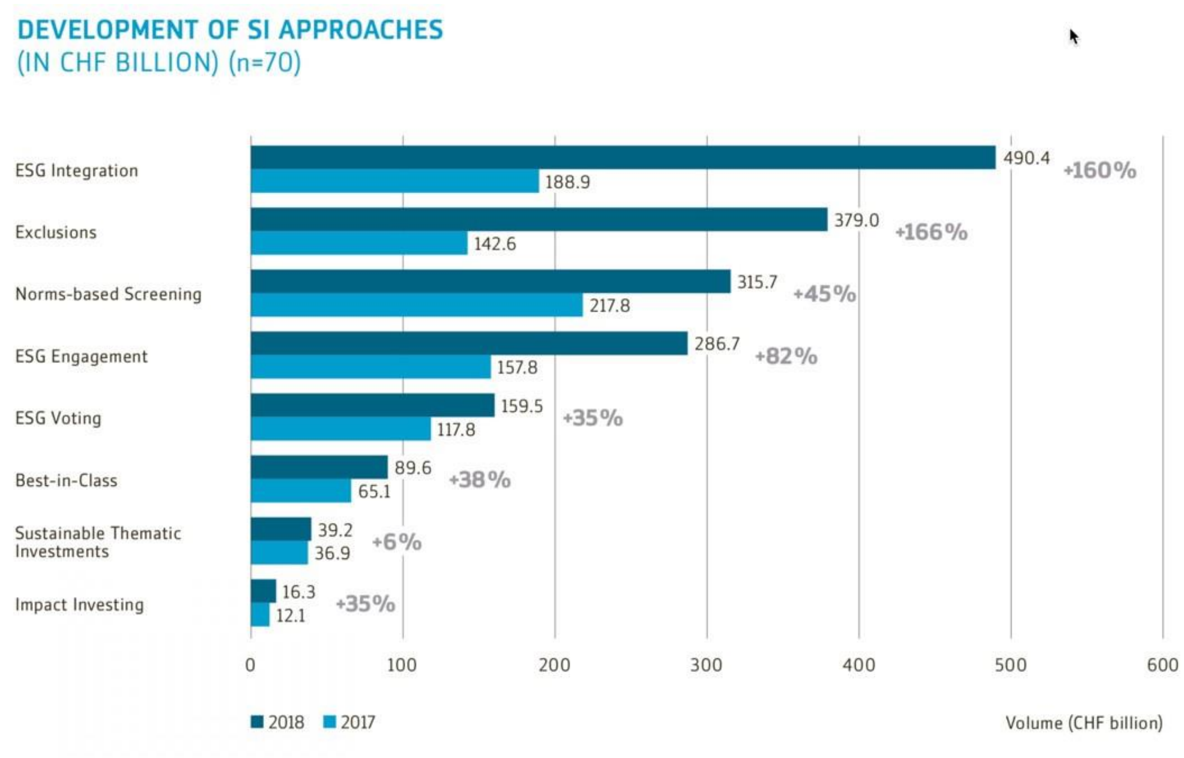
Switzerland's Top 8 Sustainable Investment Approaches

Andrew Douglas, Aug 29

The Swiss Sustainable Finance (SSF) Institute's 2019 Market Study, found that sustainably managed assets in Switzerland increased by a staggering 83% in 2018 alone. While this surpassed what the Institute expected, it is not surprising given the vested interest Switzerland has in achieving positive sustainability outcomes. With a flourishing tourism industry, vast natural beauty, sensitive microclimates in alpine areas and a socially conscious population, achieving positive sustainability outcomes is a high priority.

In addition as financial regulation has tightened, greater transparency has been given to investors regarding fees and profit margins for traditional financial products have fallen. As a response, Switzerland's financial sector has needed to adapt. Part of the response has been to become an internationally renowned hub for sustainable finance.

On the demand side investors and in particular millennials, women and institutions, are looking to companies to move beyond pure profits towards broader goals incorporating solid corporate governance, social consciousness and careful stewardship of the environment. Increasingly many companies are realising that the short-term thinking that can be brought about by only targeting the next earnings call is unsustainable. Businesses already incorporating best practices in sustainability are poised to achieve greater market share in the long run as both consumers and regulators catch up to those not taking sustainability seriously.



Assets under management in Switzerland by sustainable investment approach

After reading the SSF report I was inspired to delve deeper into the 8 approaches to sustainable investing shown above. As I discovered, the advantage of these approaches is that they can be combined and many are applicable across asset classes. Investors looking for a well-diversified portfolio across all the major asset classes now have the tools necessary to integrate sustainability goals throughout their entire investment process. The following research piece explores the details of these 8 approaches:

8. Impact Investing

2018 Volume: 16.3bn CHF

YoY % Increase: 35%

Definition:

The Global Impact Investors Network (GIIN) defines impact investments as “investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return”. This differs to other sustainable investment strategies, as the primary intention is to proactively pursue a positive impact on environmental, social and governance (ESG) outcomes rather than use current or past ESG performance as the criteria for investment.

Some impact investments actively seek areas where environmental and social issues present commercial opportunities and actively pursue positive financial returns in parallel to social objectives, while others acknowledge the tradeoffs between social objectives and financial returns and may not expect to achieve positive financial return.

While this could mean that philanthropy, charity or investing in companies that unintentionally achieve positive social outcomes could be considered impact investing, this is not the case. The GIIN has defined 3 criteria that an impact investment must meet:

1. Intentionality

Impact investments must intentionally contribute to positive social and environmental solutions and not just avoid negative outcomes.

2. Financial Returns

Impact investments must seek a financial return. While returns may be below market or only in line with inflation, an investment objective must be stated. This distinguishes impact investing from philanthropy.

3. Impact Measurement

Investors need to measure, report and target the social and environmental performance of their investments.

Strengths:

The advantage of impact investing is that investors can target a broad range of specific social and environmental criteria. Impact investing can be directly linked to causes that individual investors or institutions wish to target, such as climate change, poverty alleviation or women's rights. Well-constructed impact investments give investors the opportunity to achieve very clear goals and directly see the impact of their investments in ways broader sustainable finance approaches cannot provide.

Impact investing has the advantage of proactively seeking social and environmental opportunities that can provide benefits in the future. Other strategies are often based on an assessment of the current situation and reward what is, rather than what could be.

Weaknesses:

Impact investment can only be as good as the measures used to assess whether non-financial objectives have been achieved. Some objectives are more difficult to quantify than others and there may not be a standardised approach to assess whether the investment has delivered on its stated purpose unlike with purely financial criteria. For enhanced flexibility one may need to trade off consistency.

The universe of impact investments is much smaller than the traditional investment universe and there may only be a handful of suitable investments for an investor wanting to achieve a specific goal. Impact investments are usually made outside public markets thus liquidity issues often arise. These factors combined may be the reason for the smaller size of the impact investment market and why institutional investors favour other approaches where a larger investment universe and greater liquidity can be found.

Lastly because of the constraints described above, constructing a fully diversified multi-asset class portfolio for the long term purely from impact investments is almost impossible. Therefore it is suggested that impact investments may up a portion of a broader sustainable investment portfolio rather than the entirety of the portfolio.

Market Highlight:

Yova Investments is an innovative platform for impact investing, primarily targeting retail investors in the European market. Retail investors can select issues that they personally care about while Yova researches and seeks out companies connected to those issues to invest in. Investors may then track the financial as well as the social/environmental returns that their investments make through the Yova app.

7. Sustainable Thematic Investments

2018 Volume: 39.2 Bn CHF

YoY % increase: 6%

Definition:

Sustainable thematic investments allow investors to focus on a particular theme, issue or topic they are interested in or believe will be profitable. Thematic investing starts with a top down approach that considers broad macroeconomic themes such as clean energy rather than a bottom up approach analysing individual companies, as with impact investing. Due to this top down approach, sustainable thematic investments tend to be actively managed funds. The most popular theme has been clean energy while other themes have included water, clean technology and broad multi-themed funds covering several topics. Thematic investment funds can include private companies however they tend to focus on public markets so as not to be constrained by liquidity issues and achieve higher volumes.

Strengths:

Sustainable thematic investments offer investors the potential to find themes which, regardless of their contribution to social or environmental goals can be highly profitable.

Clean energy for example is not just sensible for the planet. Companies that can bring industrial scale, clean energy solutions are often top financial performers in the energy sector overall.

Thematic funds allow investors to take advantage of asset managers unique expertise in small sectors of the market, such as the clean energy sector, to be able to capture superior returns unlike broader sustainability funds that cover many sectors and a broad range of asset classes.

Weaknesses:

As with impact investing, thematic investing by nature is focused on a small sector of the market. This means that sustainable thematic investments may be an unsuitable strategy to invest an entire portfolio in. Sustainable thematic investments are however well suited to being added to more broadly diversified portfolios and at a larger scale than impact investments.

The pursuit of positive sustainability outcomes is often more blurred with thematic investments as the themes themselves such as clean energy may be profitable in and of themselves, without regard to sustainability criteria. Investing in companies involved in the right things does not grantee that those companies are doing the right things in other areas of their business. Therefore those looking for investments with a measurable impact on sustainability goals, need to have another level of due diligence before investing.

Market Highlight:

Robecosam provides a broad range of sustainable thematic funds covering topics such as sustainable food, smart water , smart materials and more. Their solutions are available to retail investors as well as institutional. The goal of their smart energy fund is “to achieve the highest possible returns over the long term. It is suitable for long-term-oriented equity investors who are convinced of the sustainable potential of the energy sector, and for inclusion in a globally diversified portfolio”. Interestingly no mention is made on the fund’s factsheet regarding measurable environmental outcomes. This highlights the question, are asset managers serious about non-financial objectives with sustainable thematic investments or are sustainable themes simply profitable themes that happen to fall under the sustainability umbrella?

6. Best In Class

2018 Volume:39.2 Bn CHF

YoY % increase: 6%

Definition:

A best in class approach to sustainable investing seeks to prioritise companies that are making the most effort in regard to sustainability and demonstrating the best practices in their industry. It does not exclude any industry on principle, however ‘best in class’ may mean a certain standard of non-financial criteria must be met in order for an investment to be eligible. Therefore if no company meets the standard in a sector, depending on the investment policy, the entire sector may be excluded. Some managers may also take into account metrics regarding those companies which are making the biggest improvements based on ESG metrics to reward positive non-financial momentum and encourage it.

Strengths:

The strength of this approach is that it does not restrict investors in their investment universe as strictly as some other approaches, it offers a methodology that can be comprehensively applied across sectors, countries and asset classes. This method is also flexible enough to be done at the sector and country level to further maximise the non-financial impact of investments. The key strength of this approach is that it rewards those companies most committed to sustainability while punishing the worst performers.

If enough investors incorporate this approach, then companies are incentivised to compete to become the best sustainability performers in their industry. An additional benefit is that companies with the highest commitment to sustainability and following the best practices will not need to make as costly changes as others nor face as high costs when regulation and or consumers catch up to their industry. Over the long term this should be reflected in increased financial return.

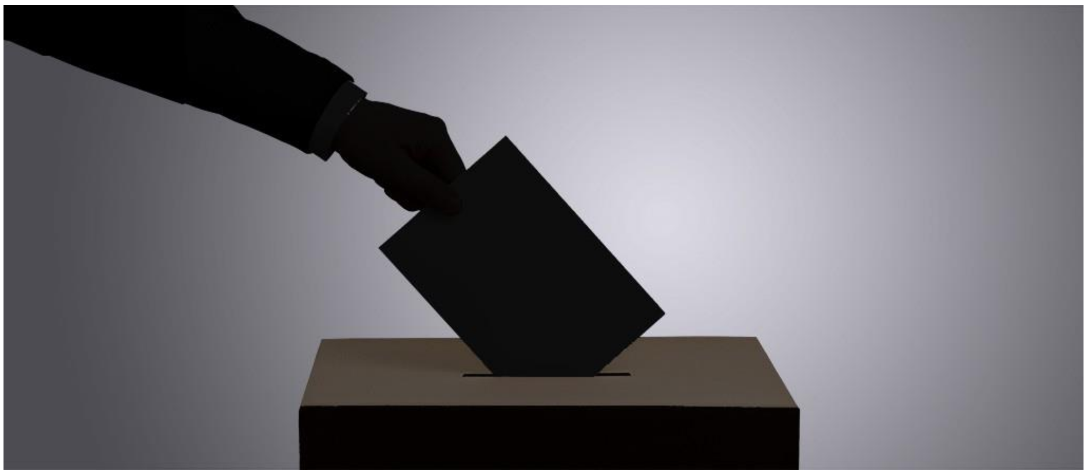
Weaknesses:

Identifying the best performers and constantly staying abreast of who the best performers are can be a difficult and costly exercise. While data is improving and becoming cheaper as more companies incorporate ESG into their investment analysis, it is still an additional cost to perform this extra research. The costs of such research and analysis is eventually borne by investors. However if the additional research means that over the long term they have selected companies who are the leaders on sustainability and avoid companies that have vulnerable revenue streams then the additional costs could be offset by the long term gains.

Market Highlight:

The Dow Jones Sustainability Index is based on a best in class approach. Funds based on this index would also therefore follow a best in class approach. The index starts with a potential universe of 10'000 stocks of which around half are invited to participate in a sustainability survey, the results of this survey is then used to identify the top 10% of investments to be used for the construction of the index.

5. ESG Voting



2018 Volume: 159.5 Bn CHF

YoY % increase: 35%

Definition:

Many public companies ask shareholders to vote on issues at their annual general meetings and allow shareholders to bring issues to the meeting to be voted on. Sustainable investors can therefore use their votes to push forward a sustainability agenda and bring issues they see as important to improving sustainability to vote. Additionally, sustainable investors may wish to punish, or reward executive and board members based on their sustainability performance by re-electing them or choosing not to. Funds which engage in ESG voting will have a formal voting policy establishing how they will vote.

Strengths:

The primary strength of this approach is that it fosters dialogue between investors and companies and is a proactive approach towards improving sustainability. While 10% disapproval on an issue, particularly concerning re-election, is not enough to get a motion rejected, it may be enough for the board and executives to open a dialogue with shareholders. There have been several successful cases where shareholders have brought issues to vote. Shell for example was asked by shareholders to investigate how they would contribute to limiting global warming to a two-degree threshold.

Another strength of integrating ESG voting into the investment process is that it is largely separate from other sustainable investment approaches and can be added as an additional layer of action taken to achieve sustainability goals.

Weaknesses:

The power of voting differs vastly from country to country. Some companies may not offer the chance to vote on issues at all. Switzerland in particular embraces shareholder voting, however annual general meetings all tend to be clustered around the same time leading to a large drain on resources for investors wishing to carefully exercise their voting rights. Additionally while voting may foster dialogue, action may not be quite so forthcoming, particularly when there may be a conflict between short term financial goals and long term sustainability objectives.

Market Highlight:

Ethos offers a sustainable proxy voting service for institutional investors and asset managers to outsource their voting. Ethos counts many of the largest pension funds in Switzerland among their clients. The benefit of this is that collectively they can exact a much higher influence on issues than any individual shareholder could do alone.

4. Shareholder Engagement

2018 Volume: 159.5 bn CHF

YoY % increase: 82%

Definition:

Shareholder engagement involves actions taken by shareholders, in addition to voting, whereby shareholders take part in a long-term process to attempt to influence a company's business conduct. The central aspect of this process is dialogue between the management of companies and investors or their representatives. The focus of such engagement may not only be to seek progress on ESG issues but also to seek greater transparency and ensure that companies publish data regarding ESG issues.

Strengths:

There are two potential benefits to shareholder engagement, the first is shareholders may guide companies toward ESG goals, the second is that by enforcing greater transparency on things like carbon emissions this data can be incorporated into the investment process allowing further optimisation of the portfolio toward sustainability goals. Like ESG voting, shareholder engagement shares the property that it can be used to improve existing investments and is therefore able to be added relatively independently to a sustainable investment process.

Weaknesses:

Shareholder engagement can be a long process whereby no change is implemented. If companies and shareholders cannot see eye to eye investors may have no choice but to divest from the company. After this no further shareholder engagement is possible.

Market Highlight:

In addition to sustainable voting Ethos offers services to institutional investors who wish to pursue shareholder engagement allowing them to pool together their efforts to have a greater impact and greater chance of positive outcomes. This is a great service as it allows asset managers to focus on managing the assets for their beneficiaries while allowing experts to engage in pursuing sustainability goals through methods that could potentially be a large resource drain if performed internally.

3. Norms Based Screening

2018 Volume: 315.7 Bn CHF

YoY % increase: 45%

Definition:

Norms based screening is the practice of analysing whether companies are in compliance with a set of international standards regarding human rights, environmental protection, corruption and labour laws. The result of this analysis is then used to exclude companies in violation of those standards from the investment universe or if a company is already held in the portfolio, trigger engagement or divestment.

Norms based screening differs from other approaches described in that a violation of one standard may be enough to exclude a company regardless of their overall commitment to ESG issues. This differs from other forms of ESG analysis which can weight up to 100 factors to come up with an overall ESG score, but may allow a violation in one area to be made up for with other positively scored areas. This also differs from topical exclusions such as alcohol, tobacco and weapons which may not violate international standards but are part of an industry that is objectionable to certain investors.

The most common framework used for norms based screening is the UN Global Compact which is a voluntary commitment to a set of values which companies can formally commit to. Commitment is not however a prerequisite for investors to screen companies against the principles and exclude them. The Global Compact is probably the most comprehensive set of principles available as is drawn up from more specific global standards such as the ILO conventions, the Universal Human Rights Conventions and the Rio Declaration on Environment and Development, hence it is the most popular set of standards for Norms based screening.

Strengths:

Norms based screening gives investors, asset managers and companies a common set of standards to work against. It also means that companies engaged in practices that violate one standard, such as manufacturing cluster-bombs, cannot be included due to good corporate governance in other areas. Through more asset managers and institutional investors adopting a norms-based screening approach, it also incentives companies to formally commit to standards such as the UN global compact and proactively report on the standards.

By investing in companies that already adhere to global standards and remain scandal free investors are rewarded with more sustainable earning that are not as subject to regulatory or customer scrutiny.

Weaknesses:

Norms based screening is focused more on excluding companies already violating global standards and asking those who begin to violate standards to change, rather than proactively rewarding those companies who are proactively pursuing sustainability goals and have strong governance processes. Investors need to decide if this is the approach they wish to take.

Interestingly or shockingly among the top 20 companies that are excluded for norms violations, 7 are members of the S&P 100 and FTSE 100 indices. Not being able to invest in such companies has large implications for being able to passively invest using a norms based approach.

Lastly data on violations may be even harder to obtain than ESG data as companies may not be forthcoming with their violations, therefore it can be a research-intensive process determining whether companies violate standards.

Companies such as RepRisk are combatting this weakness however through maintaining a database of all known violations of the UN global compact which asset managers can purchase to enhance their norms based investment processes.

Market Highlight:

Credit Suisse offers a Sustainable International Bond Fund with an objective of generating an above average return and regular stream of interesting. The fund combines norm's-based exclusions with value-based exclusions (discussed next) while also performing best in class screening. This hybrid approach means that not only does the fund punish companies doing the wrong thing as would be the case with pure norms based screening but it also rewards companies who are doing the right thing.

2. Exclusions

2018 Volume: 379.0 Bn CHF

YoY % increase: 166%

Definition:

Value-based exclusions are the exclusion of companies, industries and sectors which are incompatible with an investor's values.

Common issues to exclude are weapons, nuclear power, animal testing, genetic modification of organisms, gambling, pornography and alcohol. This method of screening is perhaps the simplest to understand as it simply means avoiding companies that operate in industries incompatible with certain values, ethics or principles.

Strengths:

The strength of this approach is it allows investors to align their investment policy to their own individual values. If they do not wish to engage with something personally it makes little sense to support such industries with their investments. Exclusions may act as a starting point for a broader sustainability framework including some of the other approaches discussed.

There exist many well-established index providers who publish their indices with common exclusions and have long track records. This makes value based exclusions practical to implement and not as resource intensive as other sustainability measures. This factor also allows exclusions to be one of the only options available to passive investors to engage in some form of sustainability practice.

Weaknesses:

It is questionable whether all value-based exclusions are concerns with sustainability in and of themselves. Companies who are actually championing sustainability may simply be morally incompatible with individual investors rather than having negative environmental and social impacts. Additionally, it is questionable as to what extent a company needs to be materially exposed to an industry before it should be excluded.

A study in 2016 showed that if you excluded all companies on the MSCI world with any involvement in controversial businesses you would need to exclude 47.4% of those companies. If on the other hand you allowed a 5% revenue exposure to controversial businesses then you would only need to exclude 9% of the industry. Thus, investors need to decide what level of involvement in controversial activities is acceptable relative to how broadly they want to invest.

Highlight Offering:

iShares is Blackrock's exchange traded fund business. As many investors have demanded passive investments based on values such as excluding controversial weapons and tobacco as well as the availability of indices such as MSCI world excluding these industries they offer many products for investors interested in such exclusions. In my opinion it is debatable whether to count these as sustainable investments, as sustainable investing should go further than to just exclude a few industries some investors find morally objectionable.

1. **ESG Integration**

2018 Volume: 490.4 Bn CHF

YoY % increase: 160%

Definition:

ESG integration is the explicit inclusion of ESG risks and opportunities into traditional financial models and in the investment decision process. There is no set formula as to how this is done and many firms choose to keep their models and processes proprietary in order to retain an edge over the rest of the market.

A quantitative example of how ESG integration might work would be the enhancement of a financial model that tries to use future earnings to value a company by adjusting the models estimate value of a company upwards or downwards according to how the company has performed based on ESG factors. From another perspective two companies in the energy sector may have the same projected earnings, however one might have a product mix that favours renewables and therefore the long-term earnings could be adjusted upwards in the model to favour this company as the other companies earnings derived from non-renewables could be considered less stable in the long run.

Alternatively, ESG integration can be more qualitative where analyst recommendations, such as buy, hold or sell, also take into account the risks and opportunities revealed by ESG data. The integration of ESG data need not stop at the company level either, as often ESG analysis at country and sector level can be useful for constructing a well-rounded sustainability focused portfolio.

Strengths:

ESG integration is highly flexible and it is encouraging to see more and more asset managers and institutions including ESG analysis into their investment processes. In theory clever integration of ESG data should see investors outperform the market by financial measure in the long run as well as on sustainability measures.

Additionally as ESG factors range far and wide, this gives asset managers the opportunity to innovate and find new ways of using ESG data to earn above market returns. Proprietary models can also be a source of differentiation between asset managers providing a healthy source of diversity and competition within the sustainable finance industry. These key factors may go a long way to explaining why ESG integration as a technique occupies the top spot in terms of volume in Switzerland.

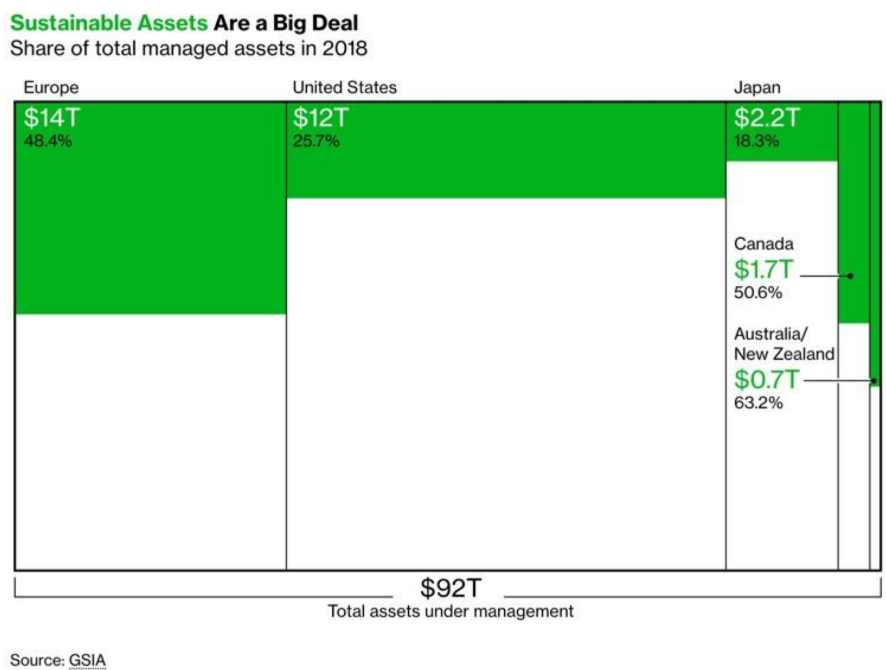
Weaknesses:

As noted with several of the other approaches ESG integration may simply be another layer of analysis to contribute to the goal of enhanced overall returns if ESG integration allows analysts to reach more accurate valuations. While this is a good thing, it means that ESG integration alone may not be enough to merit a funds consideration as a sustainable investment. The fact that many funds keeps their investment models as proprietary may also make it difficult to assess an asset managers commitment to achieving sustainable goals.

Highlight Offering:

In 2017 the CFA institute and the Principles for Responsible Investment arm of the United nations came together to publish guidance and case studiesregarding how asset managers could integrate ESG factors into their investment process. This is a useful resources as it outlines exactly how different asset managers have used ESG data in order to enhance their investment process. It gives transparency into what ESG integration is and is not and also acts as a guide and set of standards for new practitioners to begin include ESG analysis into their traditional investment processes.

Conclusion



Sustainable finance is blossoming globally with a growing portion of assets being managed in a sustainable way. As issues such as global warming become unable to be ignored it will become more and more important for all asset managers to include sustainable finance approaches into their traditional analysis.

However Similarly to the nutrition industry where not all foods branded as healthy are good for us, not all sustainably managed asset are invested with the intention of achieving non-financial goals. As we have seen, it important to go beyond sustainable branding and look into the details of the investment process to really determine if an asset manager is serious about sustainability and looking to achieve more than just financial goals.

In my opinion this represents the next evolution in sustainable finance where asset managers can be rated/audited independently for their sustainability approach and investors can have the transparency they need to ensure that their assets are being invested in complete alignment with their own sustainability goals and desires for a better planet for us all.

Andrew Douglas, CFA