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Sustainable Swiss Private Banking since 1841

Sustainable Investment Spotlight

Sustainable Investment Research, Bank J. Safra Sarasin
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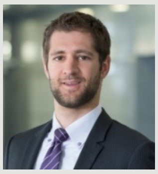
Authors



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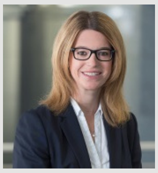

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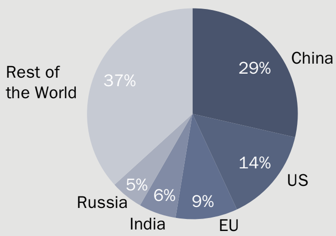
Chart 1: US share of global CO2 emissions



Source: World Bank, 2013

The Paris Climate Agreement

The Paris Agreement, adopted in December 2015 at the Paris COP21 Conference, is a global climate agreement involving 195 countries who collectively emit 95% of global CO_2 emissions. It aims at carbon neutrality in the long run while keeping global warming below 2°C. It is based on individual commitments from participating countries within a technical and financial cooperation framework, involving both the public and the private sector.

Implications of the US election for sustainable investors

- **Despite the political uncertainty created by the newly elected US president, we expect the global trajectory towards a low-carbon economy to remain on track.**
- **Social inequalities in the US are likely to rise on the back of private tax reform and uncertainties around healthcare, education and the minimum wage.**
- **Tax proposals will benefit most US companies and help address the issue of aggressive tax planning.**
- **Current political upheaval offers opportunities for governments, institutional investors, and multinational companies to re-affirm their sustainable development agenda.**

In 2016, reality has proven the polls wrong more than once. In November, sudden market reactions to Donald Trump's election victory in the US indeed reflected the surprise. However, after digesting the news, it became apparent that there might be more positives than negatives for the economy in the short and perhaps also the medium term. From a sustainability oriented longer-term perspective, the picture might look different.

Some headwinds, but no storm in the transition towards a low carbon economy

As in every area addressed during his campaign, the new president Donald Trump has made bold statements about the environment including: "I believe in clean air… but I don't believe in climate change." while suggesting that the Environmental Protection Agency (EPA) would simply disappear under his presidency. Since the election results, proposals have become more reasonable and the EPA should now "refocus on its core mission of ensuring clean air, and clean, safe drinking water for all Americans." Likewise, green energy has not been dismissed in sole favour of fossil fuels, instead the objective is to make "full use of domestic energy sources, including traditional and renewable energy sources."

Nevertheless, there is a clear intention to dismantle a variety of recent environmental legislation, for instance the Clean Power Plan while also stepping back from environmental diplomacy and leaving the Paris Agreement.

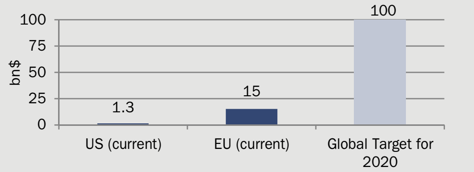
The US Clean Power Plan

Proposed in 2015 by President Obama, the Clean Power Plan is a nationwide plan aiming at reducing carbon emissions from energy production in the US while fostering the development of renewables. It is currently on hold and being examined by the Supreme Court.

The impact of a step back in environmental action would not be neutral. The US is indeed the second-largest contributor to global CO_2 emissions (see chart 1), while investments in climate action are significant.

Over the past years, US federal annual expenditure related to climate change mitigation has indeed approached $20bn, of which $1.3bn is dedicated to international climate action (see chart 2).

Chart 2: US financing of current international climate change mitigation efforts



Source: European Commission, HSBC, Bank J. Safra Sarasin, 2016

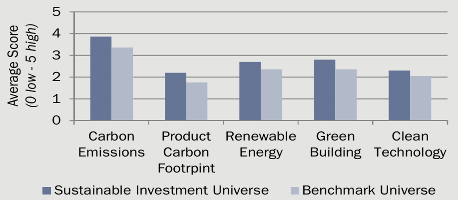
As global emissions (chart 1) and financing for climate action (chart 2) suggest, other countries also have a significant stake and an even bigger impact in the transition towards a low carbon economy.

The Paris Agreement did indeed officially entered into force shortly before the elections, with the ratification threshold being passed by a wide margin. Indeed, 112 countries representing 79% of world emissions have currently ratified the agreement. Consequently, a US retreat would not undermine the pursuit of the process. Messages from the UN Climate Conference held this November in Marrakech (COP22) have made the point clear. China and Saudi Arabia notably, reaffirmed that a potential US retreat would not derail their efforts to shift towards a greener economy. By the same token, 360 companies, including Nike, Unilever and DuPont, have issued a public call to the US president-elect not to leave the Paris Agreement, while restating their own commitments.

Such statements highlight not only the strength of global climate action but also the role of non- or sub-governmental actors in addressing climate change in the US and globally. One such example has been the 2009 Regional Greenhouse Gas Initiative, creating a cap-and-trade system across 9 states in the North-East of the US, which provides effective state-level solutions to tackle climate change. More recently, California spearheaded an international coalition of subnational entities to address climate change in the same spirit as the Paris Agreement. This Under2 Coalition has now been joined by 165 entities from 33 countries, including 18 US states and cities such as New York and Los Angeles. In the private sector, corporate efforts to shift towards renewable energy sources and the retreat of financial institutions – e.g. JP Morgan or Wells Fargo – from coal financing notably due to fiduciary duty and reputational concerns will likewise support the energy transition independently from federal action.

The need for corporates to prepare for and contribute to a low-carbon economy therefore remains acute and highly relevant to investors. At Bank J. Safra Sarasin, the thorough analysis of companies' climate change efforts is an integral aspect of our sustainable investment analysis. It identifies risks and opportunities from an investment point of view. As a result (see chart 3), issuers in our investment universe are better positioned to thrive in a low carbon economy.

Chart 3: Are companies ready for the low carbon economy?



Source: MSCI ESG, Bank J. Safra Sarasin, 2016

Inequalities in the US likely to rise

Income Tax

An in-depth reform of the US federal tax system has been stalling for more than a decade due to the lack of bi-partisan agreement. A Republican majority in both the House and the Senate could now unlock the situation. Mr Trump's vision is closely aligned with past Republican proposals that would have far-reaching consequences for individuals' taxation, with greater benefits for the wealthiest part of the population. As calculated by the Citizens for Tax Justice organization, 44% of the expected tax cuts would indeed go to the top 1% earners while the average tax change for the lowest 20% earners would represent only 1.3% of their income vs 5.1% for the top 1% (see table 1). Cuts in capital gains and inheritance tax also point in this direction.

Table 1: Impact of Mr Trump's tax plan on individuals' taxation (by earnings brackets)

	Lowest 20%	Middle Categories	Top 1% Earners
Average income	*15,100$*	*83,047$*	*1,723,100$*
Average tax change	*- 200$* *- 1.3%*	*-1,347$* *-1.6%*	*- 88,410$* *- 5.1%*
Share of total tax cut	*2%*	*54%*	*44%*

Source: Citizens for Tax Justice, Bank J. Safra Sarasin, 2016

Health Care

The announced repeal of the Affordable Care Act could suggest that health care reform will not be on the Trump agenda and that pharmaceutical companies might benefit from less scrutiny of their (pricing) practices. Given the heightened degree of media and public attention on the issue over the last few months, as well as repeated statements made by Mr. Trump on the necessity of fostering affordability while making clear that "everybody's got to be covered", there will be pressure to deliver on this topic. Besides, rolling back a measure that has so far benefited millions of Americans could prove politically difficult. The trajectory might hence not be too different from the one set by the Obama administration although the means certainly will be.

Minimum Wage and Education

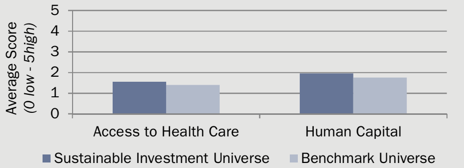
Discussions also revolved around wages and education during the election campaign. Both topics can substantially contribute to rising inequality levels. Mr. Trump's intention with respect to these points is not fully clear. However, he stated his support for a nationally applicable minimum wage of ten dollars per hour. It remains to be seen if Congress will support such a proposal. Mr. Trump expects the federal states to lead the charge in this debate, which is already happening to some degree. In general, tax reform seems to have higher priority. Education is at the very root of inequality issues and one clear path to better opportunities. While the topic did not feature prominently during the debates, it seems that Mr. Trump's intention is to privatise public schools – no high-performing country with regards to education applies this strategy currently – reform the role of teachers' unions and downsize the Department of Education.

Solutions from the ground up

Amid such uncertainties, change will also be driven by progressive US states and businesses. Pharmacy Benefits Management companies, for example, have a direct mandate to keep costs at reasonable levels. Their role is to negotiate prices and rebates with pharmaceutical companies on behalf of Insurers and Government Plans. As a result, increases in drugs' list prices over the last years have been contained by about 30% according to IMS health, a specialised health researcher. Furthermore and although California recently failed to instigate a drug pricing standard, more ballots are already planned, starting with Ohio next year. This is why anticipative health care companies have started exploring new ways of pricing their products and services based on treatment effectiveness and a patient-centric view. Likewise, and from a broader perspective on equality, companies have long understood that promoting good employment conditions results in a more stable and motivated workforce, while attracting knowledge and know-how.

The need and opportunity for corporates to develop their activities with equality in mind is therefore a prominent feature of the sustainability landscape and is included in our analytical framework.

Chart 4: Are companies addressing inequalities?



Source: MSCI ESG, Bank J. Safra Sarasin, 2016

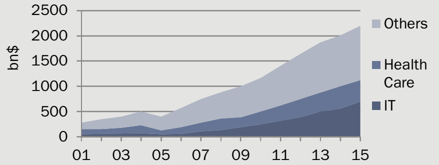
Companies in our investment universe therefore display superior credentials on related metrics (see chart 4), accounting for better management of immediate and long-term business risks, as well as a stronger orientation towards sustainability opportunities.

Corporate tax reform: profit boost and receding tax planning

A second aspect of the proposed tax reform targets US businesses. Here again, full control of Congress means that a historical reform is now likely to be passed. Companies across the board would benefit from lower tax rates, with IT and pharma companies benefiting most from lower taxation on offshore profits. Mr. Trump's proposal consists of a corporate tax rate reduction from 35% to 15%, a 10% one-off tax on repatriated offshore profits and an optional expensing of capital investments in exchange for giving up deductibility of interest payments to reduce profit shifting.

This would likely result in an increase in Earnings Per Share, estimated at an average of 8% by Goldman Sachs. Likewise, the one-off tax on offshore profits repatriation would have important implications for companies' ability to distribute cash currently held overseas to shareholders. Arguably, some companies have been bypassing this issue by issuing (cheap) debt in the US in order to keep on distributing excess cash. Nevertheless, based on past similar tax holidays, an estimated $500bn of offshore cash could be repatriated at a low tax rate – out of a total of some $2.2tn (see chart 5) – thus boosting share buybacks and dividends.

Chart 5: Profits accumulated overseas by US-domiciled corporates



Source: Credit Suisse, Bank J. Safra Sarasin, 2016

A significant cut in the US corporate tax rate would furthermore make aggressive tax strategies such as inversion deals less appealing or even unnecessary. Consequently, some US multinationals might have the opportunity to rethink their tax practices and reduce the related reputational and legal risks. Tax optimization nevertheless remains a hot topic globally, with a total annual cost of $240bn, as estimated by the OECD. The Base Erosion and Profit Shifting project launched by the OECD and EU's progressive move towards country-by-country tax disclosure requirement highlight the growing pressure in this area.

A corporate tax cut in the US also bears the risk of intensifying international tax competition. The UK for example, has already announced similar measures, targeting a 17% corporate tax rate by 2020. Global deflation in corporate tax rates would increase concerns over the sustainability of public finances, notably in countries with high debt loads, the US being a good example. The lack of details on how the proposed tax cuts would be financed – to compensate a roughly $5tn income loss over 10 years, see table 2 – along with greater infrastructure spending indeed calls into question the sustainability of Mr Trump's reforms.

Table 2: Federal revenue loss estimates from the Trump tax proposals over the next 10 years

Individual	*-3,730/-2,100 bn$*
Corporate	*-2,633/-1,936 bn$*
Estate	*-300/-174 bn$*
Total	***-6,663/-4,210 bn$***

Source: CTJ, Tax Foundation, Tax Policy Center, 2016

The way forward for sustainable Investors

While the US election has created uncertainties about how the US government will address key sustainability topics such as climate change and social inequalities, we remain positive that the global trajectory towards a low-carbon economy will remain on track. We take this view based on strong and vocal commitment and market pressure from institutional investors and multinational companies. Additionally, many state and municipal initiatives will be supportive of efforts to address climate change challenges. With respect to the rising inequality gaps, we are seriously concerned about the mid- and long-term impact on social cohesion in the US in particular. As a sustainable investor, Bank J. Safra Sarasin remains fully committed to integrating environmental, social and governance factors in its investment decisions while engaging directly with companies and thus actively contributing to and benefiting from progress towards a sustainable development.

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Sustainability Rating Methodology

The environmental, social and governance (ESG) analysis of companies is based on a proprietary assessment methodology developed by the Sustainable Investment Research Department of BJSS. All ratings are conducted by in-house sustainability analysts. The sustainability rating incorporates two dimensions which are combined in the Sarasin Sustainability-Matrix® :

- Sector Rating: Comparative assessment of industries based upon their impacts on environment and society.
- Company Rating: Comparative assessment of companies within their industry based upon their performance to manage their environmental, social and governance risks and opportunities.

Investment Universe: Only companies with a sufficiently high Company Rating (shaded area) qualify for Bank J. Safra Sarasin sustainability funds.

Key issues

When doing a sustainability rating, the analysts in the Sustainable Investment Research Department assess how well companies manage their main stakeholders’ expectations (e.g. employees, suppliers, customers) and how well they manage related general and industry-specific environmental, social and governance risks and opportunities. The company’s management quality with respect to ESG risks and opportunities is compared with its industry peers.

Controversial activities (exclusions)

Certain business activities which are not deemed to be compatible with sustainable development (e.g. armaments, nuclear power, tobacco, pornography) can lead to the exclusion of companies from the Bank J. Safra Sarasin sustainable investment universe.

Data sources

The Sustainable Investment Research Department uses a variety of data sources which are publicly available (e.g. company reports, press, internet search) and data/information provided by service providers which are collecting financial, environmental, social, governance and reputational risk data on behalf of the Sustainable Investment Research Department.

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