Sustainable Investments

Sustainability Newsletter of J. Safra Sarasin Asset Management

July 2018

Editorial

Can emerging economies be sustainable?

Dear Reader

Emerging markets (EMMA) are the growth motor of the global economy. The International Monetary Fund (IMF) forecasts growth of 4.9% in their gross domestic product (GDP) in 2018, compared with just 2.5% in industrialised countries. This significant growth differential has existed for almost 20 years. Since China joined the WTO in 2000, the Middle Kingdom has evolved from a low-income nation to the world's second biggest economy after the USA. An extrapolation of current economic and population growth rates shows that India will become the world's largest economy by 2050.

Risks and rewards in EMMA countries

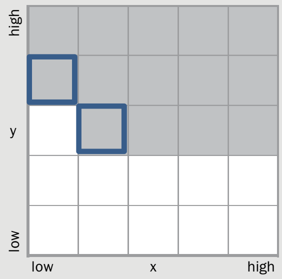
Such stellar growth presents both risks and opportunities for investors. The opportunities are obvious, considering the performance of the MSCI Emerging Markets Index, which returned over 30% in 2017. Pressure is building to invest in these markets, but the associated risks have surfaced in 2018. Both Argentina and Turkey are grappling with currency risks due to home-made economic policy problems. Meanwhile in Brazil, protests against higher fuel prices by truck drivers have brought the entire country to a standstill and are holding the government to ransom. Poland and Hungary are undermining the rule of law and press freedom. Despite the latest "Green 5-year Plan", China is still the world's biggest producer of greenhouse gases and is battling with high smog levels in its cities, while groundwater levels continue to drop, threatening the industrial base.

Source: iStock

Sustainability is a powerful lever

Is it possible to invest sustainably in countries dominated by raw materials production, poor working conditions, lack of transparency and political instability? We think this question misses the point. Emerging markets are suppliers and the extended workbench of companies based in industrialised countries, and therefore need to be integrated into our framework for the sustainability analysis. Indian and Chinese technology companies are already challenging America's dominant position. Particularly in regions dogged by greater environmental and social risks, in-depth analysis can make a difference. Governance often tends to be the crucial factor that stops investors from committing their capital. Furthermore, sustainably minded investors have a much more powerful lever: capital is scarcer, transparency can still be significantly improved and active dialogue with the management is more effective.

Sustainability matrix for EMMA countries



Y sustainability of the company
X sustainability of the industry
■ Investment universe

Source: J. Safra Sarasin

Modified sustainability analysis

To cater for the special features of emerging countries, we use a modified sustainability matrix for emerging markets which incorporates two additional quadrants in our Best-in-Class ESG investment process. Only those companies in the shaded area, i.e. those with an above-average sustainability rating, are included in our investment universe. We are convinced that sustainability analysis will pay off particularly in emerging markets. You can find out more in this edition of our newsletter.

Best wishes,
Jan Amrit Poser
Chief Strategist and Head Sustainability

EM Equities: When Sustainability Meets Quant

The attention towards the integration of Sustainability (or ESG) into quantitative investment processes has intensified in the recent period. Having seen greater interest from clients with more media coverage on the subject, we have investigated the effect ESG has on stocks from the broad Emerging Market benchmark and which factors help explaining the merits of such an approach.

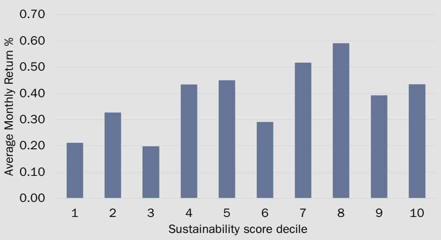
The implementation of Sustainability depends on the tolerance towards non-compliant companies.

Sustainability analysis can be applied to a quantitative investment process in many ways. However, the fundamental question for an investor is if sustainability is only limiting the investment universe or whether it is actually an alpha driver. The answer to this question is important, because integrating sustainability will have an impact on the ability of an investor to achieve a low deviation from a traditional benchmark (tracking error) or exploiting growth in certain sectors.

Is sustainability driving outperformance?

Using a sustainability score, we ranked all stocks within the MSCI emerging market index into deciles and measured their monthly returns. We found some evidence that sustainable stocks delivered superior returns. However, the strongest returns have not come from the most sustainable decile.

Sustainability: Decile Monthly Performance



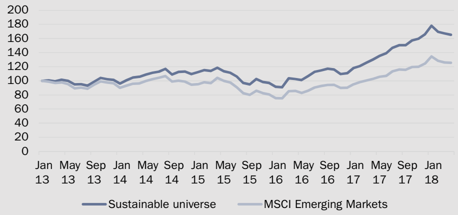
Source: Sarasin & Partners, Bloomberg. Stocks are grouped into deciles by sustainability score. The first (last) decile contains stocks with the worst (best) score. Deciles contain ca. 80 stocks. Period considered Jan13 until April18.

What is the impact of excluding stocks from the Emerging Markets universe?

Our analysis shows that a portfolio containing only stocks from our sustainable universe, weighted by market capitalisation and rebalanced on a monthly basis, has outperformed the MSCI Emerging Market Index. It is also worth noting that the risk profile, measured by both the volatility as well as the drawdown (high to low), has improved.

Sustainable vs Benchmark

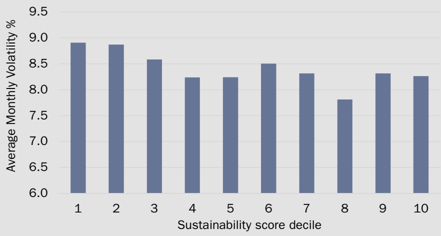
Cumulative Returns Since 2013



Source: Sarasin & Partners, Bloomberg. Sustainable portfolio contains approximately 275 stocks, weighted by market cap. Period considered Jan13 until April18.

Volatility of sustainable portfolios

Decile monthly volatility



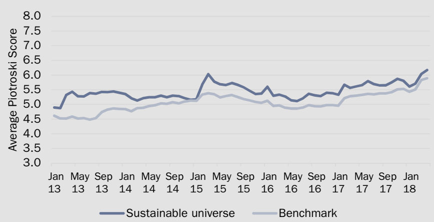
Source: Sarasin & Partners, Bloomberg. Stocks are grouped into deciles by sustainability score with the first decile containing stocks with the worst score. Deciles contain ca. 80 stocks. Period considered Jan13- April18.

Is sustainability a proxy for Quality stocks?

Some academic literature suggests that the outperformance of ESG may be due to the quality of stocks. Our preferred measure of the factor Quality is the Piotroski Score, which assesses the strength of a company's balance sheet focusing on its profitability, liquidity, operating efficiency and leverage. Quality is considered as an anomaly to efficient market theory, which states that higher returns are achieved by taking more risk. However, in reality higher quality companies have outperformed in the long term.

Weighted average Piotroski Score

Sustainable vs Benchmark

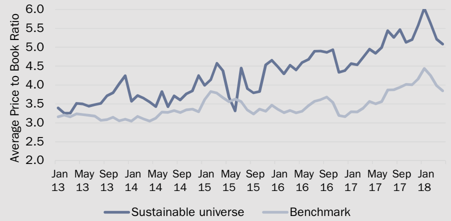


Source: Sarasin & Partners, Bloomberg, weighted avge. Piotroski score for sustainable universe vs. benchmark

Our analysis shows that the sustainable portfolio has consistently invested in stocks with a higher Piotroski score. This means that sustainability introduces a tilt towards companies with positive cash flows, increasing profit margins, decreasing leverage and increasing asset turnover

Weighted average Price/Book Ratio

Sustainable vs Benchmark



Source: Sarasin & Partners, Bloomberg. Jan13- April18

Are sustainable companies cheap?

To answer this, we have measured the weighted average price/book ratio of the sustainable universe vs the benchmark and found that sustainability tends to prefer companies trading at a higher multiple (expensive) which could also be interpreted as a tilt towards growth. It is evident that companies deemed less sustainable have experienced higher volatility as well as lower returns. While this can be useful in a stock selection process, excluding stocks from the benchmark has resulted in outperformance with lower drawdowns, which may benefit investors looking for a more absolute risk profile. While this effect can be attributed to quality factors, sustainable stocks tend also to be more expensive, so a combination of other factors such as value, momentum, low volatility and size might further enhance the investment process.

Andrea Nardon

Sarasin & Partners, Partner, Head of Quant

A brand new approach for a rather new world

"To reap a return in ten years, plant trees. To reap a return in hundred years, cultivate the people" said Ho Chí Minh, President of Vietnam. Performance has and will always be in the center stage of preferences of financial investors. Sustainability analysis is one way to gain deeper and more comprehensive insights into investment cases. We are striving to improve our knowledge in Emerging Markets bonds, not only, but importantly by integrating ESG considerations into portfolios.

It is all about the long run

As the former president of Vietnam reminded us, long term performance is what should really be the focus; in particular, when navigating through a volatile world like the one of Emerging Markets. Recent technological developments along with important social and cultural shifts in modern society have brought us to a brand new era where changes are fast, priorities are obscure and leadership is flawed. It has affected our personal lives but above all, it has been shaping a new business environment where companies are facing unforeseen challenges, new demands, as well new opportunities – which is the most interesting aspect from our perspective as investors. Businesses that manage to define (and are positioned to manage in the future) clear paths with the changes in the world focusing in the long run will ultimately prevail, and this task has never been as hard as today.

Achieving sustainability in a more demanding world

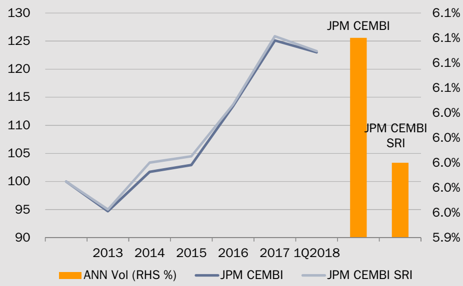
The pursuit of wealth is intrinsic to humans. But wealth must be viewed in different ways. On the one hand, we have considerable material wealth but on the other hand we also observe intangible wealth derived from social equality, from the sustainable use of resources within a stable environment where accountability and ethical values prevail. When we conceive some sort of sustainability approach in choosing investments we are looking for companies whose strategy is aligned with what society also measures as immaterial wealth. And, thus, these companies should form the core of our selection. In particular, from the mindset of a fixed income investor, we favor companies that beyond thriving and offering a good performance in the short-run, are positioned to survive in the long run. In the end, we want companies that can pay their debts. Our ESG method is an important tool which helps us to identify these positive examples.

Emerging Market companies have a lot of room to improve

Estimates point to the fact that more than half of the whole spectrum of investors is either invested or contemplating investing in ESG strategies.[1] It is clear that the subject has become mainstream in our investing world. It is also understandable that this trend has first started in the Developed World.

Our studies show that only 60% of Corporates in Emerging Markets are classified as Responsible, and only 30% as Sustainable.[2]

Performance of different benchmarks



Source : JPMorgan Research June 2018, J Safra Sarasin

At the same time that this poses a big challenge for investor to create portfolios with integrated ESG analysis, we believe this also offers a big opportunity for the near future. A recent study from JPMorgan has shown that the group of countries with higher ESG score (from their methodology) has offered better performance over the recent 5 years (Figure 1). More importantly is to see how sustainable portfolios offered a lower average volatility over the same period.

Perhaps the biggest advantage to being focused on ESG in Emerging Markets at this stage is to foresee improvements in the part of the universe which is not yet very highly developed in this aspect. We understand that most of these countries rely heavily on the exploitation of basic resources and it takes time for the economy to shift structurally towards more renewable alternatives as well as better social practices. The opportunity thus lies in investing in companies in very early stages of sustainable development as well as in countries with cheap access to sustainable resources not yet widely exploited. The good news is that these companies often have positive momentum in their ESG scores, which is an additional driver for performance.

Sustainability as a risk dimension

We believe an optimal combination between traditional financial analyses with the integration of ESG aspects will unlock the most value for our clients. Above all, for a long term investment approach, we look for quality and stability. Beyond what it is seen in more traditional financial approaches, the utilization of an ESG screening process offers an important risk management tool to define investment themes.

The analysis does not come only from a raw absorption of the data. We certainly convey a certain level of subjectivity from our analysts and this is key to identifying long term trends for different types of business. Our aim is always to maximize wealth of our portfolios by accessing not only their ability to generate cash flows, but also their ability to interact and influence positively their environment and have positive externalities.

Gabriel Cedismondi
Asset Manager
EmMa Fixed Income

[1] JPMorgan : ESG - Environmental, Social & Governance Investing – March 2018
[2] BJSS Sustainability Research, June 2018

Sustainability analysis of emerging-market countries

The need to integrate sustainability criteria in the analysis of sovereign bonds

Giving due consideration to sustainability aspects has long been a key element in the sustainable investment strategies adopted by Bank J. Safra Sarasin. Their importance has continued to grow in recent years due to factors such as political polarisation and the Paris Agreement on climate change, etc. It is becoming increasingly clear that the ability of a country to meet its financial obligations depends not only on financial and macroeconomic factors, but also on aspects such as the political environment, social capital and the impacts of global climate change. This is even more true for the analysis of emerging-market (EMMA) countries, as the financial data are in some cases unreliable or simply not available.

Sovereign bonds account for a substantial share of the total global capital market volume, at roughly a quarter (Bank for International Settlements, 2016) and institutional investors often have substantial holdings. The integration into investment analysis of sustainability criteria with a more long-term perspective complements traditional credit ratings, which tend to take a more short-term view. This approach is therefore effective for sovereign bonds as well, as they tend to have longer maturities.

UN Sustainable Development Goals (SDGs)

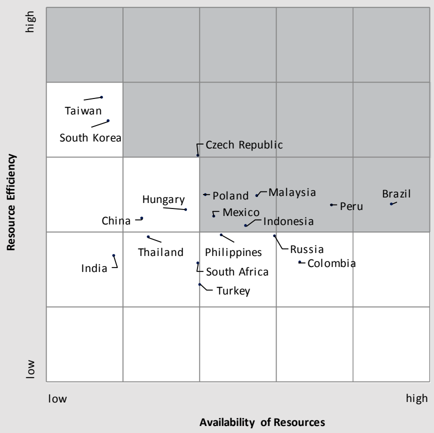
Source: United Nations, 2015

Another "pull factor" for considering sustainability criteria in the analysis of sovereign bonds is the Sustainable Development Goals endorsed by the United Nations in 2015. While some of these goals are valid worldwide, others are particularly relevant for EMMA countries and developing nations (e.g. education, capable institutions).

Sustainability analysis of countries at Bank J. Safra Sarasin

To assess the sustainable economic performance of a country, we apply our Sarasin Sustainability-Matrix® and for each country we analyse the availability of resources on the one hand (X axis), and resource efficiency (Y axis) on the other. Natural, financial and human resources are essential for a country's development and competitiveness. But the availability of these resources is not the sole success factor: they also need to be used efficiently. For this to happen, there has to be good political governance and properly functioning institutions. All countries in the grey shaded area of the Matrix® are included in the sustainable investment universe.

Sustainability Matrix® – Emerging Markets



Source: J. Safra Sarasin, selected EMMA countries. Examples are for illustration purposes only and make no claims for completeness

Our approach encompasses a total of 198 countries, uses nearly 100 public accessible data points (provided by the World Bank, the OECD, the IMF and Transparency International etc.), and integrates into the analysis various risks relating to public debt. These can either be mid-term risks, such as demographic challenges, or longer-term risks such as climate change. All these changes that occur over the course of time influence growth rates and ultimately also debt and financing aspects. A trend factor that makes allowances for the direction of a country's development over the past three years is also systematically integrated. This is particularly important for EMMA countries, as even incremental changes in the area of sustainability can lead to credit re-ratings.

EMMA countries have a mixed sustainability performance

The sustainability performance of emerging-market countries tends to be mixed (see results on the left). They are overexposed to certain sustainability risks and their institutions are typically less developed, which reduces the ability of political decision-makers to act effectively in crises. Climate change, for example, is a global problem, but so far the physical impacts have been more noticeable in emerging economies and developing countries. Positive aspects, on the other hand, include the absence of demographic challenges at present and the ready availability of natural resources. The most important aspect for EMMA countries is to appreciate the strength of the legal and the institutional infrastructure. Factors such as unemployment or corruption play an important role when it comes to assessing a country's stability and the legitimacy of its institutions, as well as its ability to repay debt.

On balance, the integration of sustainability criteria allows a more holistic analysis that complements traditional credit ratings. This is particularly important where EMMA countries are concerned, due to the data challenges described previously. In general terms, these countries need to be capable more than ever before of mastering complex new tasks to make sure they are still in a position to meet their financial obligations in the long run. Sustainability analysis provides additional indications of whether such challenges are being effectively tackled.

Andrea Weber
Sustainable
Investment Analyst

Selected sustainability profiles and ratings in the second quarter of 2018

Xinjiang Goldwind Science & Technology – Chinese Windtech for the energy transition

Xinjiang Goldwind Science & Technology is a Chinese company providing wind technologies (e.g. turbines) and managing wind farms. It is also involved in the development and operation of water treatment plants and solar power generation projects. Given its focus, the company is well positioned to benefit from China's environmental ambitions at national (e.g. Industrial Green Development Plan) and international level (e.g. Green Silk Road Fund). From a social perspective, measures addressing operational and cost related risks are above average in peer context while governance practices are in line with industry standards. Overall, Xinjiang Goldwind Science & Technology demonstrates a management of sustainability topics commensurate to its exposure to related risks while being positioned on key megatrends in emerging markets and globally. The company is therefore eligible to the sustainable investment universe.

Prudential plc – creating access to finance products in emerging markets

Prudential is an international life insurance and financial services group headquartered in the UK. Recently, Prudential's board approved a "Cyber Defense Plan". The company currently lags peers in disclosing its efforts with regards to data security and privacy measures. There is also no evidence of certification of respective efforts yet. On the opportunity side, the company is active in Asian markets and offers a variety of products to the local, fast-growing and partially still under-served middle class population. In 2016, Prudential also bought the Ghanaian micro-insurance provider "Express Life" to provide life insurance products to low-income individuals. Going forward, the company remains fairly well positioned to capture such niche-market opportunities. This and a sound human capital approach as well as a good corporate governance set-up positively contribute to the above average sustainability rating of the company.

Kosmos Energy Ltd. – a distinguished Oil & Gas company

Kosmos Energy Ltd. is an American oil and gas exploration and production company focusing on frontier and emerging areas along the Atlantic Margin. The Company operates in the exploration and production of oil and natural gas segment. Due to its geographic distribution of businesses, Kosmos faces various high risks. The company has strong anti-corruption practices. It also provides employee training on ethical standards and provisions for whistleblower protection are in place. Additionally, Kosmos has an exemplary health and safety record with zero fatalities for the 2012 - 2016 periods. However, on the environmental side, Kosmos does not disclose emission reduction targets, and its operations are not officially certified. Overall, the sustainability rating for Kosmos is above average.

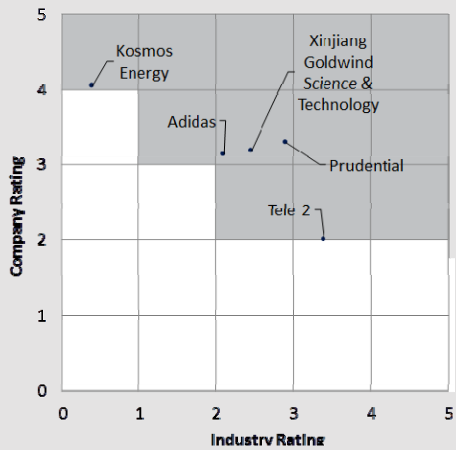
Adidas – the journey never ends

Adidas is continuously working towards becoming a more sustainable company. In 2016, Adidas surpassed most of its goals, including carbon reduction, certified materials sourcing and hazardous chemical phase-out, and set new targets for 2020. The company thereby established six strategic priorities (water, energy, material, people, health and action) to address the issues and challenges of the spaces where sport is made, sold and played. Along with Nike, Adidas is spearheading the industry's efforts in product stewardship through the reduction of resource use throughout the supply chain and the sourcing of sustainably produced materials. Adidas discloses names and locations of its sub-contractors, a best practice in supply chain transparency. However, the journey towards more sustainability will never end as various challenges related to sourcing in low-cost countries remain part of the industry's business model.

Tele2 – proactive on anti-corruption policy

We believe Tele 2 is leading in terms of addressing corruption risks in emerging markets and is also a good example of a contributor to "access to telecommunication" in developing countries. When establishing its Kazakh subsidiary, the company placed anti-corruption policies at the core of its operations. It put in place, for example, strong independent control teams which are auditing the business on the ground. External communication on these safeguards has also been best-in-class, with webcasts organized with the COO of Kazakhstan. This allowed the company to invest safely in a long-term growing market, which also benefited the local population in terms of access to mobile services.

Sarasin Sustainability-Matrix®



Sustainable Investment Universe

Source: J. Safra Sarasin, selected issuers, these examples are provided for illustrative purposes only are non-exhaustive, ratings as of June 2018

Sustainable Investment Research

Broader discussion of sustainable investments

Global initiatives to promote sustainable development are encouraging wider support for sustainable investments. As a thought-leader and pioneer in sustainability, Bank J. Safra Sarasin is actively involved in this discussion. The rapid increase in the number of events focusing on sustainability confirms the growing interest of investors in this topic. The latest study published by Swiss Sustainable Finance on the Swiss market for sustainable investments reports dynamic growth of 82% over the period 2016 to 2017.

Promoting sustainable investments

The Paris Agreement on climate change and the publication of the UN Sustainable Development Goals in 2015 represent major strides towards putting sustainability on the global political agenda. In the meantime, various working groups are busy fleshing out the details of these proposals. Many of the committees involved have presented their findings during the first half of 2018.

The European Union's **High-Level Expert Group** has submitted concrete recommendations for strengthening support for sustainable investments. These include a classification system or "taxonomy" on what is sustainable, and a label that allows tax breaks. Integration of ESG factors is likely to become part of an institutional investors' and asset managers' fiduciary duty.

Switzerland's **State Secretariat for International Finance** (SIF) is also considering making sustainability a fiduciary duty. A free pilot test has allowed pension funds to measure the climate risks in their portfolios.

The **High-Level Commission on Carbon Pricing**, led by Nobel Laureate of Economics Joseph Stieglitz and Professor Sir Nicholas Stern, has also submitted its recommendations. The experts reckon that prices in the range of USD 30 to 100 per tonne of CO_2 are necessary to ensure the energy transition is completed in good time.

More and more sustainability events

The prospect of tighter regulations and the group pressure to participate in international initiatives to combat climate change is fuelling significant interest from investors looking for more information about sustainable investments. In the first quarter of 2018, for example, we played a prominent role in a record number of events. At the **Sustainability Roadshow** organised by **Investments Pensions Europe (IPE)** we presented our approach, which integrates sustainability aspects in every step of the investment process. At the **Institutional Investor Forum in Cologne** we talked about the portfolio risks associated with climate change, and debated them in a panel discussion with representatives from an insurance company, a foundation and Germany's Bundesbank.

Jan Poser speaking at the Institutional Investor Forum, Cologne, Germany

Source: Institutional Investor,

One of the special highlights was the **German Foundations' Conference 2018 (Stiftungstag)**, an event where we presented the opportunities and risks of an intelligent energy transition. Along with Professor Claudia Kempfert from the German Institute for Economic Research (DIW) and Michael Dittrich from the German Federal Environmental Foundation (DBU), we discussed how investors can profit from this trend.

The **ESG & Impact Conference** organised in April by Société Générale in Frankfurt provided insights into all aspects of sustainability, from corporate social responsibility to sustainable investments.

Panel at SocGen ESG & Impact Conference

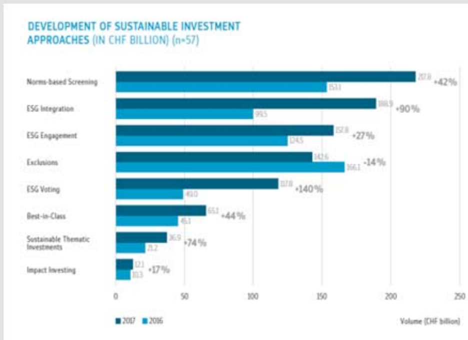
Source: SocGen, J. Poser on the right, speaking

But quantitative investors are also becoming increasingly interested in sustainability. In February we gave a presentation explaining how a quant and ESG approach can be combined, at a conference organised by the **Chartered Alternative Investment Analyst (CAIA) Association in London**.

Sustainability was also a major topic at our **Institutional Investors' Day in Bern**, where we held workshops to explain how ESG aspects can be integrated into different asset classes.

At the **Geneva Forum for Sustainable Investments** (GFSI) we presented our successful research approach for disruptive technologies in the light of ESG analysis.

Switzerland: growth of ESG approaches



Source: Swiss Sustainable Finance, 2018

Dynamic market growth

The number of events reflects the growing interest from investors in integrating sustainability into the investment process in a smart way. This is also evident in the dynamic growth of the sustainable investments market, which is now in double digits for the whole of Europe. At the start of June, the **Swiss Sustainable Finance** association published its market study, which estimates growth of 82% in the **Swiss SI market**. This figure includes pension funds, which have joined forces to form the Swiss Association for Responsible Investments (SVVK) and are now pushing ahead with putting their investments on a sustainable footing. Here J. Safra Sarasin is on hand to provide active support for all types of investors.

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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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