

# Adding value through active engagement

UBS Asset Management's **stewardship strategy**



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# Introduction

This paper explains UBS-AM's stewardship strategy in light of two key trends that have emerged within the asset management industry: a shift from active to passive strategies, and the rise of sustainable investment as a central topic for mainstream investors. With significant capabilities across both active and passive, as well as a clear commitment to leadership in sustainable investing, UBS-AM is uniquely positioned to help clients benefit from both of these trends.

This paper explains the profound implications we believe these developments carry for the future of asset management. It discusses the evidence from both internal and external research of the material value of sustainability more generally and stewardship specifically, as well as outlining UBS-AM's approach to stewardship and its application to both our active and passive strategies.

In our view, engagement and proxy voting activities play a key role in driving sustainability integration. Corporate engagement deepens our knowledge of, and confidence in, the companies in which we invest. As such, we regard it as an intrinsic part of the investment process, offering unique opportunities for differentiation and innovation that realize positive material change for companies and better long-term returns for our clients.

## Passive and sustainability

### **The emergence of a new "active" asset management**

The shift from active to passive has transformed the asset management industry over the past decade and has accelerated during the past two years. Prior to 2008, passive investments were a niche offering; today, passive equity allocations account for over 70% of invested Japanese public equity assets and more than 50% and 35% of US and European allocations, respectively.<sup>1</sup>

In many respects, this move has corresponded with significant pressure on fees paid by asset owners to asset managers. We would argue that increasingly, active managers have struggled to demonstrate returns that consistently outperform the market over time, while index-oriented strategies have offered diversification of risk to clients for minimal cost. In this context we contend that asset managers need to rethink the fundamental value proposition that they provide to their clients. While assets have increasingly shifted toward passive,

<sup>1</sup> See Bernstein, "Trust in Asset Management?: Fees, Investment horizons, and setting better goals," February, 2018, pp. 5-17.

sustainable investment (SI) has grown significantly. What once was considered niche has now clearly become mainstream. Interest stands at an all-time high, with the United Nations-supported Principles for Responsible Investment (PRI) now representing over 2,200 signatories and more than USD 80 trillion in assets.<sup>2</sup> Today, many of the largest asset owners globally are leading the SI movement, developing increasingly sophisticated approaches to integrating sustainability into their investment strategies and mandates.

In 2005, Eurosif measured the core European SRI market at EUR 105 billion and a broad market at EUR 1.033 trillion—ten years later it was reporting EUR 736 billion of assets in best-in-class, thematic and impact investing strategies and more than EUR 10 trillion in broad exclusion strategies.<sup>3</sup> In its 2018 Annual Report, PRI said 87% of its responding signatories were integrating sustainability into directly managed assets. This transformation reflects the fundamental discussion of the long-term purpose of asset ownership, and the social function of asset management.

We believe the trend toward passive investing and the growing interest in sustainability are closely related.

Firstly, as asset owners move their equity assets increasingly toward passive strategies, they are less exposed to stock or manager specific failures. However, they are increasingly exposed to unmanaged, longer-term systemic and socio-economic risks, which impact the long-term returns of the markets as a whole. As a result, they are placing increasing emphasis on longer-term sustainability issues, such as climate change and aging populations, as well as growing socio-economic inequalities that are directly linked to economic instability. Increasingly, they expect asset managers to take these longer-term issues into account when making their investment decisions.<sup>4</sup>

Consequently and secondly, the rise of passive investing has provided an opportunity for passive managers to take a more proactive role in solving large, systemic sustainability issues through stewardship, in the form of engagement and proxy voting. The influence of passive managers has grown as their stakes in markets have increased, and many large passive managers have become increasingly vocal in upholding shareholder resolutions that support sustainability goals linked to long-term value creation. As passive assets have grown, so too has the potential power to influence and shape corporate agendas.

Finally, the emergence of smart beta and rules-based strategies has coincided with a move toward differentiating active strategies through sustainability integration. Increasingly sophisticated quantitative approaches have replaced many more traditional fundamental strategies. This in turn has created a demand for new methodologies within active asset management that cannot be replicated by rules-based approaches by focusing on longer-term drivers of performance, which inevitably overlap with sustainability issues. This entails integrating material sustainability signals in order to invest in line with the long-term value of companies.

As active managers move towards more concentrated portfolios, they are dedicating more resources to engagement and voting activities for the companies in which they invest. Rather than merely basing investment decisions solely on an analysis of a company's reported results, active managers are increasingly establishing longer-term relationships with investee companies, and working with them to improve long-term drivers of value. Such active company dialogue and collaboration provide a means of differentiation from passive investing. It can also give rise to a number of positive outcomes: better informed investment decisions, positive impacts on a company's business performance and therefore alpha generation, as well as creating benefits for the environment and society as a whole.

<sup>2</sup> <https://www.unpri.org/about-the-pri>

<sup>3</sup> See Eurosif SRI Study 2016: <http://www.eurosif.org/sri-study-2016/>

<sup>4</sup> See for example, Richard Morrow, "GPIF CIO laments passive manager stewardship plans," Interview with Hiromichi Mizuno, *Asian Investor*, March 28, 2018.

# Sustainability and financial performance

## Our internal evidence

While sustainability and stewardship clearly provide an opportunity for differentiation and added value, it is important to address the essential question: what is the evidence that sustainability integration and stewardship provide additional alpha generation and enhance long-term client returns?

A significant number of studies have focused on the relationship between sustainability and financial performance over the past decade, using a wide range of approaches, data sources and methodologies. Overall surveys of these studies have generally concluded that integrating sustainability does not harm performance and can lead to a longer-term enhancement of risk-adjusted returns.<sup>5</sup> While the external evidence of such research is encouraging, we believe any strategy around sustainable investment should be grounded in solid internal research as well. Consequently, UBS-AM has conducted quantitative research into the impact of sustainability on returns in order to establish a solid, evidence-based foundation from which we can drive our sustainability integration and stewardship strategy.

Our internal back-testing has examined the UBS proprietary factor driver score. This score is grounded in an objective and consistent set of sustainability metrics that are scored using the SASB materiality map<sup>TM</sup>, which identifies the most relevant sustainability factors per industry, as a starting point.<sup>6</sup> Through this quantitative analysis, we can better understand and control the inputs into our sustainability variables, as well as control how the score correlates with financial performance.

We examined the performance of an MSCI World Index strategy that is tilted using the UBS factor driver scores, where companies with higher scores are given a higher weighting while companies with poor scores are underweighted

compared to the MSCI World benchmark. We developed a scenario where the resulting average score of the ESG (Environmental, Social and Governance) tilted index is increased to the greatest possible amount while maintaining sector allocations in line with the underlying MSCI benchmark. This led to a 1.5 point average ESG score increase on a 10 point scale in the tested portfolio vs. the MSCI World Index, which we called the "ESG Max Portfolio". We tested the performance over a long time period (December 2005–December 2017) in order to understand the impact of the sustainability signal in different market environments, including the credit crisis. Importantly, we employed a country-neutral approach to ensure the weights of the tested portfolio were not biased by differences in the score. Portfolio simulation weights were updated monthly using the ESG scores available at the time of each month's rebalancing.

The overall back-test showed a positive signal, as the ESG Max portfolio outperformed the benchmark by 8% over the whole time period, or 0.39% on an annualized basis (see Exhibit 1).

While the ESG Max performance was relatively neutral, to slightly negative during the 18 months leading up to the credit crisis, the ESG Max portfolio began to out-perform the MSCI benchmark in June of 2008, just before the worst period of the crisis in the fall of 2008, and nine months prior to the market bottom in March 2009. The ESG Max portfolio has been generally positive since the end of 2012 as markets recovered from the European sovereign crisis of that year.<sup>7</sup>

Interestingly, these results are similar to those of recent research conducted by the quantitative research team of UBS Investment Bank (IB) which tested the performance results of various tilted portfolios using sustainability scores from Sustainalytics.<sup>8</sup>

<sup>5</sup> See Gunnar Friede, Timo Busch & Alexander Bassen, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies," *Journal of Sustainable Finance & Investment*, 2015.

<sup>6</sup> See for more information <https://www.sasb.org>. For a more detailed analysis of the UBS score, please see UBS Asset Management, "Measure What Matters: Expanding the scope of intrinsic value to include ESG," November, 2017. <https://www.ubs.com/magazines/markets-research/en/white-papers/2017/measure-what-matters.html>.

<sup>7</sup> A recent study demonstrating similar results and particularly the role of sustainability as a means of better risk-adjusted returns see, MSCI, "Can ESG Add Alpha?: An analysis of ESG Tilt and Momentum Strategies," June 2015.

<sup>8</sup> See UBS, "Quantitative Monographs: Exploring ESG Investing," Dec 13, 2017.

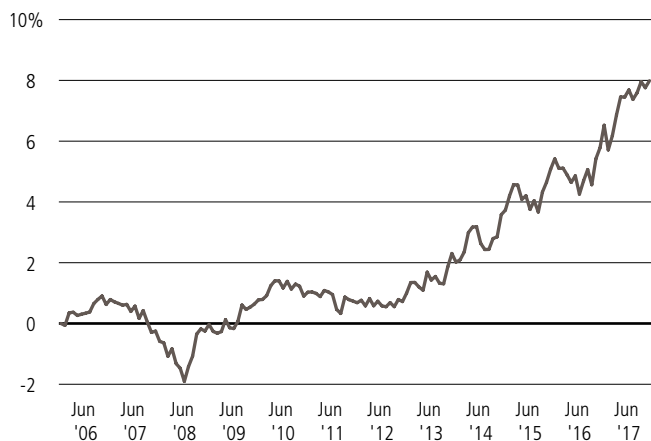
The IB results demonstrated excess returns of the ESG portfolios which ranged from 10% to 15% between August 2009–August 2017. The most significant period of out-performance also began following the resolution of the European sovereign crisis in late 2012.

Overall, the results are encouraging in demonstrating that positive performance is consistent across similar market environments and not dependent upon the specific source of the sustainability information. Importantly, both studies suggest that the sustainability signal has been particularly positive over the past five years, which may be the result of improving levels of sustainability disclosure, as well as growing

interest from investors looking to include sustainability into their investment strategies.

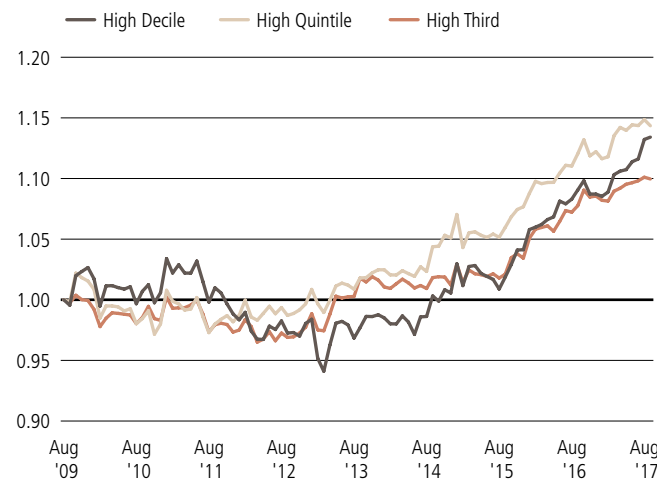
UBS' own quantitative research thus clearly supports the material importance of sustainability as a means of mitigating risks that correlates with positive financial performance over time. This evidence underpins UBS-AM's strategic commitment to leadership in sustainable investment. Working directly with companies on realizing sustainability improvements through stewardship is thereby a key means of driving positive corporate changes that we believe will lead to better investment results over time across both active and passive strategies.

**Exhibit 1: ESG Max Portfolio: Cumulative relative performance**



Source: UBS Asset Management.

**Exhibit 2: High ESG excess cumulative returns**



Source: UBS Asset Management.

# The added value of stewardship

As our Global Stewardship statement outlines, responsible ownership for UBS-AM comprises activities which monitor and, where necessary, influence corporate conduct on matters that affect the long-term value of investee companies.<sup>9</sup> We strive to build relationships with company management to foster healthy dialogue and enhance performance on a variety of issues such as strategy, performance, risk, capital structure, culture, business ethics, corporate governance, remuneration, climate change, environmental management, human capital and supply chain management.

Several recent studies demonstrate the financial benefits of stewardship through engagement.

Stewardship comprises both engagement and voting activities. Corporate engagement implies a two-way dialogue between investors and companies, with the goal of enhancing information and improving business performance, both in terms of ESG issues and strategy, risk management and capital allocation. On the one hand, investors can share their expectations of corporate management and encourage practices to enhance long-term value. On the other hand, companies have the opportunity to explain the relationship between sustainability, their business model and financial performance.

Several recent studies demonstrate the financial benefits of stewardship through engagement. Initial findings from academic research led by Professor Elroy Dimson show the financial impact of successful engagement.<sup>10</sup> The analysis found that companies investors could successfully engage with experienced improved profitability as measured by returns on assets. By contrast, companies where engagement objectives had not been met saw no change in return on assets.

<sup>9</sup> See <https://www.ubs.com/global/en/asset-management/investment-capabilities/sustainability.html>

<sup>10</sup> The sample referenced 225 investors involved in 30 coalitions. See Elroy Dimson, "How institutional investors' collective engagement on ESG issues create value for investors and corporations: A configurational analysis," Judge Business School, Cambridge University, London Business School; Chair of Strategy Council, Norwegian GPF; Director of FTSE International, 2017.

A complementary 2018 research study undertaken by Professor Jean-Pascal Gond reveals the communicative, learning and political benefits linked to shareholder engagement, showing that dialogue improves information flow and understanding between investors and corporations.<sup>11</sup> Engagement also helps generate and share knowledge about issues and trends as well as highlighting the limitations of possible practices. Finally, it demonstrates that engagement enables closer collaborations between ESG and mainstream analysts within investment firms and between operational, functional experts and board members within companies.<sup>12</sup>

These studies showing the positive financial benefits of engagement are consistent with recent research demonstrating financial out-performance from companies that improve their sustainability performance over time. Working together with companies on the most material drivers of long-term value thus represents a valuable way of generating long-term financial out-performance. This evidence serves as a strong foundation to support UBS-AM's stewardship activities as a key mechanism for adding value to clients by driving better long-term investment returns.<sup>13</sup>

### Mechanisms of engagement value creation for corporations and investors

Value creation dynamics	Investors	Sector
Exchanging information	<ul style="list-style-type: none"> <li>– Clarifying expectations and enhancing accountability</li> <li>– Managing impressions and rebalancing misrepresentations</li> <li>– Specifying the business context</li> </ul>	<ul style="list-style-type: none"> <li>– Signalling and defining ESG expectations</li> <li>– Seeking detailed and accurate corporate information</li> <li>– Enhancing investor ESG communication &amp; accountability</li> </ul>
Producing and diffusing knowledge	<ul style="list-style-type: none"> <li>– Anticipating and detecting new trends related to ESG</li> <li>– Gathering feedback, benchmarking and gap-spotting</li> <li>– Developing knowledge of ESG issues</li> </ul>	<ul style="list-style-type: none"> <li>– Building new ESG knowledge</li> <li>– Contextualising investment decisions</li> <li>– Identifying and diffusing industry best practice</li> </ul>
Deriving political benefits	<ul style="list-style-type: none"> <li>– Enrolling internal experts</li> <li>– Elevating sustainability and securing resources</li> <li>– Enhancing the loyalty of long-term investors</li> </ul>	<ul style="list-style-type: none"> <li>– Advancing internal collaboration and ESG integration</li> <li>– Meeting client expectations</li> <li>– Building long-term relationships</li> </ul>

<sup>11</sup> See Jean-Pascal Gond, "How ESG engagement creates value for investors and companies," Cass Business School, City University, 2018.

<sup>12</sup> In addition to the academic research mentioned in the text, other studies showing the financial impact of stewardship are: Dimitrov, V., and F. Gao. 2017. Social Capital and Shareholder Activism: Evidence from Shareholder Governance Proposals. *Working Paper*, Rutgers University; Dimson, E., Karakas, O. and Li, X. (2015). Active Ownership. *The Review of Financial Studies*, 28 (12), pp. 3225- 3268; Junkin, A., CFA, CAIA (2015) , Managing Director, update to The CalPERS Effect on Targeted Company Share Prices, Wilshire; Renneboog, L., Szilagyi, P.(2011). The role of shareholder proposals in corporate governance. *Journal of Corporate Finance*, 17 (1), pp. 167-188 Becht, M., Franks, J., Mayer, C. and Rossi, S. (2010). Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund. *The Review of Financial Studies*, 23(3), pp. 3093-3129; Gillan, S., and L. Starks. 2000. Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors. *Journal of Financial Economics* 57:275–305.

<sup>13</sup> For a summary of additional work on the added benefits of engagement on positive external and financial performance, see UBS Wealth Management CIO, "Education Primer: ESG Engagement Equities", August, 2018.

# Our approach to stewardship

What does that approach to stewardship look like in practice? It is important, at the outset, to articulate the commitment of UBS-AM to the principles of good stewardship. We are signatories to stewardship codes of best practice such as the International Corporate Governance Network (ICGN) Global Stewardship Principles, the UK and Japanese Stewardship codes, as well as supporting the Hong Kong SFC Principles of Responsible Ownership and the investor-led ISG Stewardship Framework in the USA. We are currently finalising the process to support for the EFAMA Stewardship Code and meet the requirements of the Australian FSC Standard 23 on Principles of Internal Governance and Asset Stewardship. UBS-AM is also a signatory to the Principles for Responsible Investment initiative, which strongly encourages investors to be active owners by engaging with companies and voting at annual general meetings (AGM) (as outlined in Principle 2).

We see corporate engagement as an intrinsic part of the investment process that deepens our knowledge of, and confidence in, the companies we invest in. Any engagement dialogue involves acquiring third-party research, proprietary data analysis, on-going assessment and information sharing amongst investment and sustainable investing staff. Our company meetings are typically held with chairmen, lead directors, CEOs, CFOs and sustainability experts. These

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interactions are led by investment analysts, portfolio managers, or sustainable investing staff, but our approach is always the same so as to ensure a unique and consistent voice from our firm.

Depending on the issue and whether the engagement activity is reactive or part of on-going discussions, our engagement with issuers can take the form of written communication, conference calls or face-to-face meetings. In addition, we maintain a comprehensive database of our company interactions in order to share information internally, review progress against defined objectives over time and follow-up on any issues that have been identified.

Where we believe the effectiveness of engagement and the chance of success can be increased, we are willing to work both formally and informally with collective bodies, or to collaborate with other shareholders. By speaking to companies with a unified voice, investors can communicate their views more effectively and allow the companies to focus on a smaller and more co-ordinated number of requests from the financial community. Collaboration with peers can bring clear benefits, such as building knowledge and skills, sharing resources and increasing attention from corporate management. However, there is a chance that negotiation and co-ordination costs might hamper the advantages of collaborating. We must endeavor to confirm at the outset that working with other investors is permitted by law and/or regulation; that a general alignment of views and agreement on issues of concern and potential solutions exist; that dialogue will be undertaken privately; and that we, as an investment firm, have the resources to effectively contribute to the research of, and dialogue with, selected companies.



We believe that voting is a key component of effective stewardship, and it is important that proxy voting is linked to our engagements with companies and our integration of sustainability more broadly. In cases where holdings are included in multiple portfolios, we aim, as far as possible, to vote consistently in order to send one strong and unified message to our investee companies. In the case of passive strategies, it could be the only tool we have to voice our opinion and encourage boards to address our concerns.

On average, in a 12-month period, UBS-AM votes on approximately 10,000 meetings. The process is supported by a third party proxy advisor responsible for issuing voting recommendations based on our internal proxy voting policy. Having a customised policy allows us to develop and update our expectations of companies on a regular basis, across a range of material topics presented at AGMs.

We also use voting to complement and support our engagement activities. In situations when our engagement dialogue is not bringing the results we had expected, we will escalate and use voting as an additional means to express our opinion and influence boards and management. In these circumstances, communications with management pre- and post-vote are essential to explain the reasons for our dissent and to open the doors for further dialogue.

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We maintain an active participation in formal and informal investor networks in order to maintain awareness of best practice in ESG matters, to foster dialogue with policy makers on ESG issues of interest for us and to improve dialogue between institutional investors and other stakeholder groups.

These include, amongst others:

- Principles for Responsible Investment
- International Corporate Governance Network
- UK Investor Forum
- UK Corporate Governance Forum
- Asian Corporate Governance Association
- US Council of Institutional Investors
- Institutional Investor Group on Climate Change and partner organizations in other regions

## UBS-AM's stewardship activities are currently organized according to four pillars:

- 1. Thematic engagements:** these are dialogues based on priority ESG themes considered material, analysed by available internal and external research and aligned with the overall sustainability and sustainable investment strategy of UBS-AM. Engagement lists are usually developed by taking into consideration the current performance of companies on the relevant topic, sectors where the issue has a high relevance, and the potential for influence and financial exposure across investment strategies. The research supporting thematic engagement follows internal scorecards developed by our sustainable investing and stewardship analysts around the issue of concern. This research is used to assess the performance of companies at the beginning and the end of the engagement program. In 2018, we selected "climate change" as a focus topic, identifying 50 oil & gas and utilities companies to engage with.
- 2. Reactive engagements:** these are dialogues with companies involved in serious breaches of international standards such as the Universal Declaration of Human Rights, the International Labor Organization's Declaration on Fundamental Principles and Rights at Work, the Rio Declaration on Environment and Development, and the United Nations Convention Against Corruption. The United Nations Global Compact Principles are considered as a general reference framework to define cases of concerns, and we have developed a system using third party research to identify red flags across portfolios and strategies. After an initial screening, we take into account the public reporting on the case, communications by the company involved, reports by NGOs and other third parties, and the results of investigations by other investors where these are available. The final engagement list includes cases that are material, relevant, or represent systematic management failure. The purpose of dialogue is to influence companies so they effectively close and remedy identified breaches and address any management failures so as to avoid repeating the mismanagement or mistake in the future.
- 3. Engagements around proxy voting decisions:** these interactions refer to conference calls or in-person meetings conducted before or after an AGM to inform proxy voting decisions and/or to communicate to companies about proxy voting decisions. While many voting decisions are taken based on internal and external research without the need for dialogue with management, in some circumstances it is important to interact with the board to gain a more detailed understanding of the vision and nature of items included for votes. These conversations can help shed light on board member candidates, remuneration policies, board effectiveness and the company's reaction to specific shareholders' resolutions. Cases for proxy voting engagements are usually identified based on financial exposure, seriousness of the concern and complexity of the item up for vote.
- 4. Analyst-led engagements:** these are dialogues conducted by the analysts and portfolio managers on specific issues related to the business strategy and/or ESG risks and opportunities that may have a positive or substantial impact on valuation models. These interactions with corporate management are conducted with the goal of collecting more information and influencing corporate practices to trigger better financial performance in the long term. The identification of companies for this type of engagement is strictly linked to the importance of ESG and long-term issues in the formulation of the investment case.

Stewardship is relevant for both active and passive strategies. In the case of active, it facilitates enhanced investment decisions for long-term value creation. For passive, it addresses broader negative externalities to the economy which could cause instability and inefficiencies within the financial markets. UBS-AM is strategically positioned as an asset manager which offers experience and a wide range of strategies across both passive and active.

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### The 4 pillars of UBS-AM's stewardship strategy

1. Thematic	2. Reactive	3. Proxy Voting related	4. Proactive
Engagements on specific sustainability topics, including climate change and impact	Engagements on topical events and UNGC breaches	Engagements centered around shareholder meeting research	Engagement following identification of material ESG risks and opportunities



Active and Passive holdings

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Source: UBS Asset Management.

# Engagement in active equities

## **Making active asset management truly active**

Probably the most significant engagements in terms of impact on the investment process are analyst-led dialogues directly tied to the investment case. Because they are conducted by UBS-AM financial analysts and portfolio managers working collaboratively with the members of the sustainable investment research and stewardship teams, their ramifications extend across all actively-managed strategies. Similarly, because they are linked to the investment cases, these engagements impact the business strategies of the companies engaged. Importantly, analyst-led engagement provides a key enhancement to active investment analysis in ways that cannot be replicated by rules- or index-based strategies.

Analyst-led engagement steers analysts toward longer-term issues that drive company value and that we believe will likely contribute to the success of the investment thesis over time. These issues often relate to the governance structure, but increasingly they are being linked to longer-term sustainability trends that have a material impact on company performance, such as climate change, environmental management and human capital performance. These dialogues generally involve reaching out to both executive and, ideally, non-executive, board members, in order to influence the company strategy. Finally, these engagements entail working closely with corporate management to take appropriate and concrete measures to unlock long term value.

In the first instance, analyst-led engagements provide unique insights into company strategy which is not possible through annual company disclosures alone. Specifically, by entering into dialogue with board members, it is often possible to obtain important clarifications around the direction of the company's strategy, as well as management's willingness and commitment to make material improvements in performance. Crucially, engagement with the board provides a unique means of understanding and testing the coherency of long-term company strategy from a perspective independent of day-to-day management.

Secondly, analyst-led engagements can be an important driver of positive change which may contribute to the success of the investment thesis itself. Generally, senior management and members of the board are receptive to dialogue on the long-term drivers of value of their company. By engaging with management on these issues and providing concrete targets for areas of improvements, we can play a role in driving successful corporate decision-making. Engagements around the long-term drivers of value are also essential in establishing trust between the investor and the company. This then provides an important foundation for further dialogue seeking to drive better long-term financial results.

Most fundamentally, analyst-led engagements linked to the investment case provide a differentiated means of creating better longer-term returns for clients. Such engagements lead analysts and portfolio managers to approach each company's investment decision as an owner, transforming the investment process from simply developing a view on the current short-term price in the market to instead making a commitment to work collaboratively with companies on realizing positive change. This ultimately has wider implications for the social purpose of asset management itself, moving the act of investment from a trading perspective in pursuit of short-term profits, to one which is truly active and contributing to positive improvements in investee companies. And in so far as the long-term drivers of value overlap with sustainability issues, this form of engagement also may lead, in aggregate, to positive outcomes over time for the environment, society and the economy as a whole.<sup>14</sup>

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In 2017, UBS-AM launched the Global Impact Equity Fund, which uses engagement as a key element of the investment process to drive positive change around the United Nations' Sustainable Development Goals (SDGs). The engagements with the holdings in the fund draw upon an innovative research collaboration that UBS-AM has with several leading universities to develop the standard for reporting on a set of impact measurement indicators. Engagements with the companies in the fund are oriented around helping companies understand the impacts on the environment and society of their supply chain, direct operations, and final products and services as well as to orient their strategies to pursue business opportunities linked to the UN SDGs.

<sup>14</sup> For example, strong supply chain supervision protects product quality and brand equity but also keeps the workers in the factory safe. Good human resource policies may keep and attract talented employees that can drive innovation and new product creation as well as improving the lives of the employees themselves. This concept was popularized in a 2011 article in the Harvard Business Review by Professor Michael Porter where he defined the concept of "shared value", that good business practices could create shareholder value as well as societal value with no compromise to economic returns.

# Stewardship in passive strategies

## Increasing the voice of investors

A common misconception in the financial industry is that sustainability factors cannot be taken into account in passive strategies as investments have to track the performance of capitalisation-weighted indexes. Similarly, stewardship activities might be considered irrelevant in passive portfolios as the manager cannot buy and sell stocks in response to the success or failure of engagement activities. However, stewardship activities acquire more relevance in passive investments as more significant portions of institutional investors' portfolios are oriented toward passive solutions. Stewardship linked to passive strategies often represents one of the most significant instruments by which institutional investors can express their views on company performance and drive long-term value creation.

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We believe that dialogue with investee companies in passive strategies is essential to raise awareness and influence corporate conduct on matters that can impact the economy overall, such as bribery and corruption, climate change or human capital management. In the case of UBS-AM, 70% of assets are managed passively. Another way to look at this is that two thirds of the 8,700 companies held on average in UBS-AM portfolios are included in passive strategies only. As analysts or portfolio managers may not follow these companies closely, the importance of proxy voting and engagement is even greater as our ability to communicate our dissatisfaction with a company's conduct by "voting with our feet" may be limited in passive strategies.

Stewardship activities linked to passive strategies tracking sustainability indexes or applying a rules-based approach can also incentivize companies to be included in selected ESG indexes, and provide meaningful insights to enhance the methodologies applied in these indices. Additionally, proxy voting policies can evolve to better reflect the sustainability objectives of these innovative rules-based strategies.

For example, UBS-AM recently developed a tilted passive strategy, known as Climate Aware, to incorporate climate change factors and meet clients' objectives on supporting a low carbon economy. More specifically, the Climate Aware strategy aims to deliver returns broadly in line with indexes of traditional developed markets while increasing or decreasing exposure to the index constituents based on their expected contribution to climate change. A 'positive' tilt is used to

increase exposure to companies providing renewable energy or supporting related technology. A 'negative' tilt is used to reduce the size of the investment in companies with worse than average greenhouse gas (GHG) emissions, energy derived from coal and large reserves of fossil fuels. Importantly the optimization process incorporates the Glide Path Probability score developed by UBS-AM to account for the trajectory of CO2 reductions, and therefore the likelihood that each company is reducing emissions in line with the 2-degree CO2 reduction scenario (the basis of the Paris agreement). The stewardship strategy on behalf of Climate Aware includes both engagement and proxy voting activities. Engagement makes it possible to share the results of the quantitative and qualitative assessments included in the fund methodology with investee companies. In addition, dialogue with companies allows for the verification of company performance with additional information collected before and after the dialogue. It also means UBS-AM can collect feedback, explicitly communicate objectives for change in corporate practices and further enhance the model used to inform the under/overweights in the strategy.

As a result of the introduction of Climate Aware, UBS-AM's proxy voting policy has also been enhanced to facilitate voting at shareholder meetings of companies around the world that need to adapt their business, strategy and corporate governance to reduce climate risks and meet globally agreed climate change goals. Such enhancements have been introduced for every investment strategy managed by UBS-AM, not just those included in the Climate Aware strategy.

## The stewardship strategy on behalf of Climate Aware includes both engagement and proxy voting activities.

Another example of the link between passive sustainable products and proxy voting policies is the recent collaboration between UBS-AM and UBS Global Wealth Management to launch the UBS Global Gender Equality ETF. This ETF tracks the Solactive Equileap Global Gender Equality 100 Leaders index, an index of 100 global companies with a strong performance on 19 diversity criteria, including equal compensation and work-life balance, transparency and accountability, gender balance, and sustainability policies. As a result of this new product development, UBS-AM's proxy voting policy now includes new provisions on gender diversity at the board level with thresholds tailored by geographic markets. As with the climate change strategy, work on a specific product has enhanced proxy voting decisions across all of UBS-AM's investments.<sup>15</sup>

<sup>15</sup> A thematic engagement on gender diversity could also offer additional opportunities to drive better corporate performance in alignment with the objectives of the ETF. An interesting focus list for such a dialogue would comprise those companies which rank close to the top constituents but are excluded from the index. The goal would be to create positive competition and incentivise these companies to enhance their practices in order that they might be included in the index in the future.

# Conclusion

The shift toward passive and rules-based strategies has presented challenges to traditional active asset management, but sustainability integration and stewardship provide new opportunities for growth and development. The requirements of asset owners have significantly increased, but so have the corresponding number of innovations through voting and engagement. Academic and practitioner's research clearly support the financial benefits of sustainable investing, and our own work provides a strong foundation to support UBS-AM's commitment to leadership in this field.

Stewardship, including the active engagement with companies and supported by proxy voting, represents a unique opportunity for asset managers to generate value, building on the unique power that they have through shareholder rights. The equity capitalization layer of a public company has special characteristics; it is the unsecured risk capital that can benefit the most from business model success and conversely bears immediate losses in case of bankruptcy. Public equity owners have strong legal authority to influence how the company is managed. The purpose of this responsibility is to safeguard the capital of the asset owners and to provide input to corporate management and the board to provide for long-term success. This success, in turn, is the key to the creation of economic value. As a large manager with ownership stakes across both passive and active strategies, UBS-AM is well-positioned in exercising this responsibility across a wide range of companies, and UBS-AM's broad ownership stakes can be used to support engagements across asset classes.

In many respects, stewardship provides a unique opportunity for asset managers to strengthen their critical and multi-faceted social function. First, investment success enables individuals to meet their needs: teachers and firemen can retire on the capital and the returns on it that they have earned in their working career. Second, stewardship protects the economic rights of the capital owner, making sure that its needs are met. Third, and more recently, the role of stewardship has expanded in scope to include the company's contribution to society in a broader sense by focusing on those sustainability issues that simultaneously help the company achieve long-term business success.

Engagement and voting on material environmental, social and governance policies is part of our core responsibility to contribute to long-term business success as well as risk mitigation in realizing competitive returns. For these reasons, ESG integration and stewardship are central to our role as a responsible asset management firm. We do not believe that they should be delegated; on the contrary, we continue to add to our resources that support active engagement and have been raising the bar in terms of activity. We also record and report our engagement activity to our clients. All of this is an important part of the social function of asset management, and it is key to the success of our clients and our firm.



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