Sustainable Investments

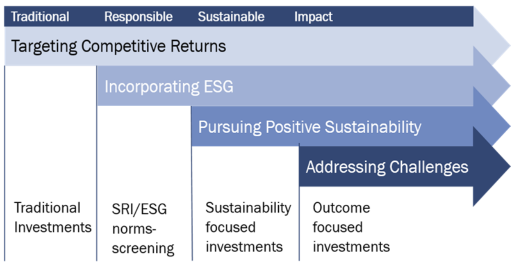
Quarterly Newsletter of J. Safra Sarasin Sustainable Asset Management
4th Quarter 2021

Four lessons from 30 years of sustainable investment

Sustainable investment is rife with misunderstanding. Here are some answers.

Dear Reader
A lot has happened since our bank launched the first sustainable investment mandates over 30 years ago. Although sustainable investments have since moved from a niche into the mainstream, there is still plenty of misunderstanding about what they actually are, what their impact is, and how sustainability should be integrated into the investment process. In this newsletter, we would like to summarise the lessons learned over the years.

Sustainability Approaches and Journey



Source: Barclays

The investment philosophy behind ESG investments is critical
Many critics, including some recent prominent ones, repeatedly claim that "ESG investments achieve very little". Here it should be remembered that investments based on ESG criteria can have quite different goals. The first – and original – category includes investments simply geared towards specific religious or ethical values, whose sole purpose is to enable an individual to invest with a clear conscience. The second generation of ESG investments attempts to consider financially material ESG issues and themes in order to identify additional risks and opportunities. These ESG investments are thus solely concerned with "single materiality", i.e. the *impact of the environment and society on companies*. This is different from "double materiality", which additionally examines *the impacts of companies on the environment and society*. So the latest generation of sustainable investments, which is also encouraged by EU regulations, focuses on impact our outcome-oriented investing with objectives. The trend is clearly heading in this direction.

ESG is not an exact science, but data are essential
The fact that ESG data are not standardised and the correlation between data providers is very low, is often used as an excuse to hold back from sustainable investment altogether. Climate scientists do of course work with hard facts, but trying to channel all sustainability goals into one single rating is definitely more art than science. Just as the needs of investors differ (see above), so too are ESG ratings different. Just like brokers who work with financial models to produce buy or sell recommendations for shares, the appraisals of ESG data providers can and should vary significantly. Identifying the right data is therefore essential. It is better to use incomplete data rather than none at all. Furthermore, data are important for providing transparency for the portfolio. Because the data are not perfect, the in-house expertise of analysts and portfolio managers is needed to check them. The data are effectively merely a starting point – it is eventually up to the portfolio managers to integrate ESG criteria into their overall analysis and decisions.

Engagement and divestment belong together
I believe a misleading debate has been raging for years about whether it is better to open a dialogue (engagement) with companies whose activities are environmentally or socially damaging, or to exclude them from investments altogether (divestment). I see these as two sides of the *same* coin. To be able to exert pressure during engagements, there has to be a credible threat of exclusion from the portfolio. Defining exclusion criteria without communicating them – and thus also without advocacy – is just as inadequate. To influence companies in a credible fashion, portfolio managers need to actively foster a dialogue, even with those firms whose shares are not (yet) in the portfolio.

Sustainability is a journey. It does not have to be achieved from one day to the next. It is far more important to embark on this journey in a committed fashion than to refrain and hesitate. This Newsletter offers a few tips and lessons on the ingredients needed to produce a credible investment process.

ESG Lesson #1: Interview with ESG Data Scientist Sebastian Wiesel on the challenge of ESG ratings

“Modern asset management is data management”

While analysts produced only qualitative financial and sustainability research 30 years ago, in today’s world sophisticated data sets are key to managing portfolios successfully. ESG is no exception!

Mr Wiesel, you are an ESG Data Scientist. What do you do exactly?
My job is to take the multiple data sets on the issuers of shares, load them into a database, aggregate them, calculate the relevant ratings, rankings and metrics, and make them available to users in our Asset Management team. These users include on the one hand portfolio managers and analysts looking into the sustainability issues of their investments, and on the other hand the Risk Office, which reports to senior management on the sustainability risks in the portfolios. There is a whole range of sustainability data that are key to assessing the risks and opportunities in investment portfolios. These include the carbon footprint as well as the revenues generated from sustainable products and services. Classical ESG factors, such as staff satisfaction, wastewater volumes and the number of product recalls are also financially material ESG data that need to be considered in the investment decision. My job is to make sure that our portfolio managers and analysts are able to access all these data.

Companies on which agencies have the same ESG rating

★ **Top Companies**
The companies below are in the top 10% across 5 major ESG rating

	Name	Ø Percentil
1	SAP	98.7
2	Siemens	95.5
3	Microsoft	95.1
4	Gecina	93.9
5	Iberdrola	93.4

Bottom Companies
The companies below are in the bottom 10% across 5 major ESG rating

	Name	Ø Percentil
1	Maruichi	3.4
2	Sumitomo	3.8
3	Liberty Media	3.9
4	ABC-Mart	4.8
5	Cabot Oil & Gas	4.9

Source: J. Safra Sarasin, illustrative table

The allegation is often made that ESG ratings vary from one provider to another. Are the data really meaningful?
When selecting data providers, it is important to consider which goals their research is targeting. The question is this: is the rating based purely on an ethical or religious view, on a risk perspective, or on an impact analysis? The ratings tend to vary depending on the goal being followed. I don’t see that as a problem. Actually this variation is a good thing, as it allows more systematic and differentiated analysis of businesses. With financial data as well, the quality and purpose of the data may differ. That’s why the share buy and sell recommendations issued by brokers often vary, even though analysts have presumably made them on the basis of *hard* financial facts. This is even desirable from the viewpoint of competition and markets. Anyone simply unwilling to trust the ratings can then use the underlying raw data and aggregate them to produce fresh, more meaningful research – which is exactly what we do.

What’s the benefit of all these data? Are they really necessary?
The first step in managing sustainable portfolios should always be to create transparency. This is a multidimensional analysis process that requires masses of data. Is the company involved in controversial activities? How risky is the sector in which it operates? Is the company managing these risks competently? Does it benefit from the major sustainability trends? Does it provide solutions for the global challenges of our time? Or does it suffer from high emissions of carbon dioxide, pollutants, wastewater and general waste? How does its value creation chain look? The vast quantities of data available allow us to show our clients the exact composition of their portfolio.

Wouldn’t it be enough to analyse the portfolio constituents?
Modern asset management is data management. Precisely *what* you have in the portfolio is just as important as what you do *not* have. To select the right companies to invest in, you need information about the entire investment universe: for example, which companies will suffer most as a result of climate change, or which would be particularly hard hit by a carbon tax. This requires enormous amounts of data and a broad coverage. Ultimately a comparison also needs to be made with a benchmark index, which is equally important for determining the ESG quality of the portfolio. Data quality and depth must be assured particularly for the bond indices, which have several thousand constituents.

What do you see as the biggest challenges as far as data are concerned?
ESG ratings can sometimes be very generalised. To get a better picture of a company, the components of the rating should be examined more closely. But it’s even more important to underpin the figures with a narrative, so that the rating itself is not some kind of black box. Data coverage is another challenge. Many of the most important sustainability issues concern developing countries, where the data tend to be particularly scarce. A key challenge is therefore finding data points relevant to impacts. Screening for controversies is important, but in future measuring impacts against the UN’s 17 Sustainability Development Goals (SDGs) will be an even bigger priority. In this respect I expect to see more progress in the near future in measuring progress towards achieving the goals set in the UN Agenda 2030.

Sebastian Wiesel
ESG Data Scientist and Sustainable Investment Analyst

Regulators focus increasingly on real-world impacts

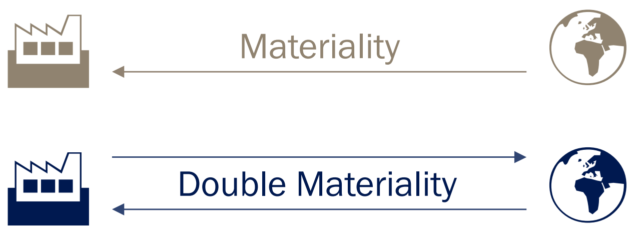
Not only do the environment and society influence the business performance of companies – companies themselves have an impact on the environment and society. This type of sustainability reporting is becoming the standard.

The foremost accounting standards IFRS and US GAAP state that all financially material factors must be disclosed in the annual reports. Sustainability reports usually start with a materiality matrix to show which sustainability issues are financially relevant for the company. But who records the material impacts on the environment? This is exactly what the principle of double materiality is intended to model.

Self-responsibility is no longer enough

After scientists have warned for years about the dangers of climate change, extreme weather events have now become commonplace. CO_2 emissions are declining much too slowly. The model of self-responsibility does not seem to be able to adapt quickly enough to the changing conditions. After the scientific consensus on climate change and biodiversity has shown a clear need for action, the EU, with its directives on the disclosure of sustainability data, is imposing an even higher level of obligation on companies and the financial sector, rather than relying on the principle of voluntary disclosure – for big corporations, at least. The minimum requirements for sustainability reporting are increasing. Following the principle of materiality in the accounting directives, the EU taxonomy now defines material business activities far more precisely.

Double materiality in a nutshell



Source: London School of Economics, 21.04.2021

Rules of play are changing

"A company should concentrate solely on maximising shareholder value." Corporate governance has generally followed Milton Friedman's doctrine since the 1970s. What often tends to be forgotten, however, is that Friedman also assigned government the responsibility for establishing the rules of play. Attempts to change the rules of play in order to integrate negative external effects such as environmental pollution into corporate governance have been ongoing for some time.

One example is the price of carbon credits in the EU Emissions Trading System (EU ETS), which has shot up from 5 euros to around 60 euros over the last three years. While these certificates were allocated to companies at no cost initially, today allowances are auctioned. Now importers of carbon will have to pay a carbon border tax as well. If the measures currently in place fail to produce the desired result, further improvements will be made until climate warming slows. A similar mechanism is expected for other sustainability issues. Double materiality is becoming increasingly prominent in policy decisions in a bid to prevent irreversible effects on the environment.

What are the key sustainability impacts?

The main data points for the EU are set out in the EU Taxonomy and the Principal Adverse Impacts in the disclosure obligations of the financial sector – with a total of 18 sustainability indicators. They range far beyond basic climate issues and include indicators on the following topics:

- Greenhouse gas emissions
- Biodiversity
- Water
- Waste
- Respect for human and employment rights
- Gender equality

Integration into the investment process

As a leading provider of sustainable investments, double materiality is also our polar star. Any company abusing human rights, for example, is excluded from our investment universe. Our climate pledge to achieve net zero carbon by 2035 sets measurable targets at the portfolio level. Our reporting also includes details of carbon footprint, temperature trends or contribution towards achieving the UN Sustainable Development Goals. Our funds are also classified in accordance with EU guidelines. All funds with a general sustainability approach can be classed as Article 8 funds, and all those with an additional sustainability goal, such as combatting climate change, Article 9. In this way we aim to ensure that client portfolios take account of double materiality.

Benjamin Gränicher
Sustainable Investment Analyst

ESG Lesson #3: true ESG integration goes beyond ratings and filtering

Credible ESG integration puts the onus on PMs

Credible integration of sustainability is more than just passing through data. It requires active cooperation between sustainability and financial specialists. Portfolio managers need to step up their game: as a core part of the investment, sustainability cannot be ignored.

From niche to mainstream

As sustainable investing made its move from niche to mainstream, several developments took the industry by storm. The number of ESG metrics and the availability of data exploded. However, many institutions were confronted with a knowledge gap on core sustainability topics. With asset inflows increasingly turning towards sustainable funds, a large incentive emerged for the industry to label itself more and more *sustainable*. But investor scrutiny around ESG integration efforts has picked up, leading to questions around the legitimacy of sustainability claims. Regulators are not standing idle either. The lack of harmonized disclosure requirements is starting to dissolve through increased regulation. The Sustainable Finance Disclosure Regulation (SFDR) is showing its impact on investors' websites and pre-contractual documentation, and by end of 2022, new technical standards will further put these claims to the test. We see increasing evidence of parties struggling with these changes, as they try to catch up. Funds that carry climate labels but count several large oil majors among their top holdings are still standard practice. In this context, we acknowledge the need for tighter regulation, especially when it comes to transparency.

Our sustainability toolkit

Source: Bank J. Safra Sarasin, 31.01.2021

It helps to have over 30 years of experience

At J. Safra Sarasin, we have been thinking about these topics for more than 30 years. As a pioneer and thought leader in the field, we see regulatory scrutiny not as another box to tick, but rather as a natural extension of what we do on a daily basis. Integration of sustainability issues into our investment process is no different.

This starts with data. We refuse to waive complexity as an excuse to forgo on the integration of data. Instead of passing through external ratings, we have improved our processes around the refinement of data for many years, leading to a proprietary in-house ESG rating. We perform industry analysis, where we select and weigh our own key ESG issues, and company analysis, where we assess and tackle company specific issues. The two are synthesized in our patented sustainability matrix.

As refined as the data may be, it falls short when it is the sole instrument for the company assessment. Take Befesa, an industrial company that recycles steel dust. Data alone suggest it is a borderline case, as its scope 1 CO_2 footprint is high. However, we consider the company to be one of the key drivers for positive environmental impact: Instead of being dumped in landfills, steel dust now gets reused. Alternatively, there are companies that pass the data test, but that we reject after in-depth analysis. Data richness and improvements will lower the number of slip-through cases over time. Nevertheless, a closer look into the company is a necessity to catch unwanted outcomes.

Cooperation leads to deeper knowledge

As the true value-added comes from deeper knowledge of investment cases, this also means doing the additional work. When we initiate a new company for our buy list, both the sustainability and financial analyst perform extensive due diligence around key performance indicators. They actively cooperate in this process to assess materiality as well as areas for potential improvement. This naturally flows into topics of interest for future engagement sessions. These are mostly attended by both the engagement specialist and the PM/analyst, where they complement each other. Again, we are not just aiming for the highest possible number of interactions to report. Instead, we once more trust in expertise from various fields to add value.

There are many other examples that show how we do things differently. Our sustainability experts are part of our daily news flow update, and our financial analysts get regular updates and teach-ins on key ESG topics. This brings sustainability to the core of our investment cases. In that context, portfolio managers are aided by expert analysis, but in no way absolved from their responsibilities to stay on top of important sustainability topics. Indeed, credible integration of sustainability shows itself through the knowledge of both experts. That includes the portfolio managers.

Marcel Voogd
Portfolio Manager Core Equities

What have we learnt from our Climate Engagements?

We have carried out 16 climate change-specific engagements related to our JSS Sustainable Equity – Global Climate 2035 fund and were pleased by the strong GHG emission reduction efforts of the corporates. Most of our holdings have made carbon neutrality pledges in order to keep global warming below 1.5°C.

Climate change mitigation is high on the political agenda…
Many nations that represent the bulk of the global greenhouse gas (GHG) emissions have committed themselves to carbon neutrality. For example, the EU, which is responsible for one third of global emissions, recently outlined its plans to meet its ambitious 55% GHG emissions reduction target by 2030 (vs. the 1990 level). They intend to accelerate the development of renewable energy, ban the sale of fossil-fuel-based cars by 2035 and extend the carbon pricing scheme to additional sectors among many other measures.

..but how does it trickle down to the corporate level?
We have observed very similar GHG reduction plans during our 16 climate-change-related engagements with our portfolio holdings. Most firms confirmed that they try to reduce their indirect Scope 2 GHG emissions (released mostly from purchased electricity) by shifting towards more renewable energy usage by either installing on-site solar or wind power generation assets or via entering virtual power purchase agreements. For example, prestige beauty company Estée Lauder has already sourced 100% of its global electricity need from renewable sources in fiscal year 2020. Energy efficiency improvements in the own operations (Scope 1 GHG emissions) are another key source of the corporates' GHG emission reduction targets. This can be achieved by the replacement of production equipment, light retrofitting or through the installation of more energy efficient heating, ventilation and air conditioning systems. Electrification of the corporate auto or truck fleet was also an often cited, but somewhat less significant source in order to trim Scope 1 GHG emissions.

Vast majority of the firms' total GHG emissions stem from Scope 3
We often observed that indirect Scope 3 emissions accounted for approximately 80-95% of the company's total GHG emissions. Scope 3 GHG emissions often originate from either the supply chain in the form of emissions embedded into the purchased intermediate goods and services or from the use phase of the products of the company. It appeared to us that Scope 3 GHG emissions are the most challenging to reduce as these fall outside the company's direct control. Nevertheless, we were impressed by some companies' efforts that made strong attempts to incorporate their sustainability goals into their suppliers' agenda for efficiency-improvements. For example, automotive supplier Aptiv specifically negotiates lower GHG emission pathways with its key suppliers. Household product manufacturer Reckitt Benckiser also demonstrated remarkable efforts by trying to reformulate its products in order to achieve a lower carbon footprint during the use products' phase.

Carbon neutrality pledges help to keep global warming below 1.5°C
Many of the corporates we reached out to set science-based carbon neutrality or net-zero carbon pledges. These ambitious emission reduction plans would allow to keep global warming below 1.5°C in the majority of cases. About half of these pledges promise to curb GHG emissions in the companies' own operations only, while the others aimed to cut emissions both in the operations as well as across the entire value chain.

Not all carbon neutrality commitments cover the same scope

Carbon neutrality/ net zero carbon pledge	2020	2025	2030	2035	2040	2050
Across operations only (Scope 1& 2)	Estee Lauder	Novartis	Aptiv Infineon Medtronic Carrier	Umicore	Reckitt Benckiser Colgate-Palmolive Sealed Air	First Solar
Across the entire value chain (Scope 1&2&3)			Novartis Equinix Hera		Aptiv	

Source: Company data, Bank J. Safra Sarasin, 9.09.2021

To the few companies in our portfolio that were behind the curve in carbon neutrality pledges, we pointed out the importance of following the Task Force on Climate-Related Financial Disclosures (TCFD) and the related best practices. We currently monitor the climate related disclosures of more than eight thousand issuers and we feed their published data to our proprietary climate engine tool that determines a global warming trajectory for each firm.

Sophisticated physical and transition risk assessments
Various firms we contacted with our climate engagement, including pharmaceutical manufacturer Novartis, carried out sophisticated stress testing to analyze the physical risks their manufacturing plants could face from increased frequency of adverse weather events and water scarcity. Novartis also factored in a USD 100/ton carbon price for carbon emissions globally for their internal decision making to determine the financial impact of the their future GHG emission related to their upcoming major capital investments. We consider this as a strong forward-looking transition risk assessment approach. In our Global Climate 2035 portfolio, we vigilantly analyze upcoming physical and transition risks to ensure that our holdings are well positioned for the upcoming energy transition.

Barbara Janosi
Portfolio Manager/Analyst Core Equities

Sustainability Rating Reviews in the universe update of the 3rd Quarter 2021

Innergex Energie Renouvelable INC. A leader in renewable in Canada

Innergex is an independent renewable power producer which develops, acquires, owns and operates hydroelectric facilities, wind farms, and solar farms for a net capacity of approximately 3.071 MW, predominantly in Canada. Because of strong climate resolutions in a number of states in Canada, the company will benefit from its positioning. According to our research, we consider the company's business activities as fully aligned with the objective to combat climate change according to the European Taxonomy. The company pays particular attention to biodiversity when deploying new infrastructure as it cooperates with NGOs and independent local bodies to minimise potential adverse impacts. Due to its strong sustainability credentials, the company is part of our ESG best-in-class investment universe.

Bekaert NV - Advanced in steel wire transformation

Bekaert is a Belgium based world market and technology leader in steel wire transformation and coating technologies. Bekaert is a global company with more than 27'000 employees worldwide, headquarters in Belgium and € 4.4 billion in combined revenue. Compared to its peers in the steel industry, the company has strong health & safety policies. The company has a heightened interest in employee development and recognition of the Brandon Hall Group's awards program, which recognizes organizations that successfully implement human capital management programs and achieve superior and measurable results. On average, each employee receives approximately 20 hours of training per year, which has led to a declining injury rate over the last three years. The company is working on new technology cable that reduce energy losses and heat dissipation, and offer a predictable and reliable coating lifetime.

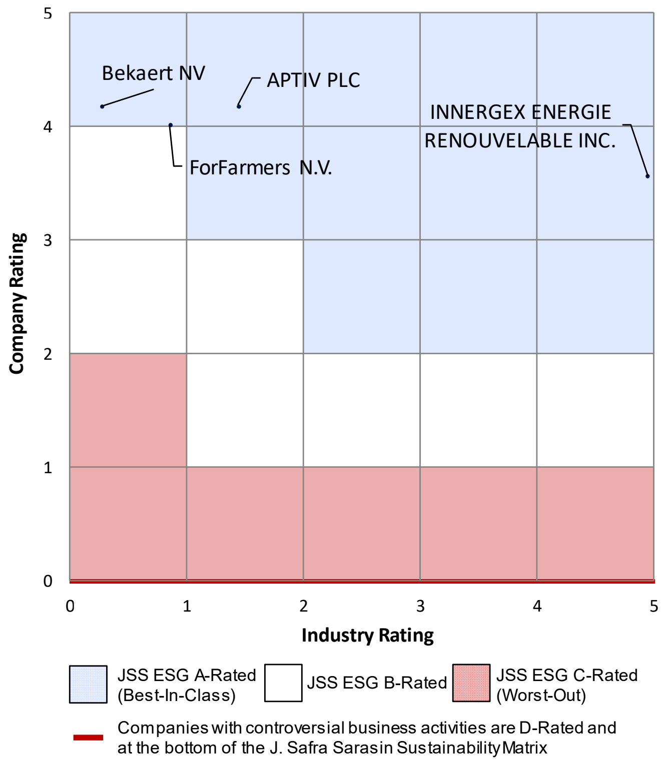
ForFarmers – Circular economy in Farming

ForFarmers is an internationally operating feed company based in the Netherlands that offers Total Feed solutions for conventional and organic livestock farming. The company has a circular strategy promoting responsible and transparent sourcing, reducing energy usage per tonne of feed, maximising use of renewable energy, reducing carbon footprint of feed delivered to farm, optimising efficiency in total animal chain, protecting soil health and biodiversity. This is underscored by their targets of 100% responsible sourced palm oil and soy bean and scope 3 CO_2 upstream reduction emission targets of -30% by 2025.

Aptiv – Safe and Green Innovation

Aptiv is an Irish auto parts manufacturer. The company operates two business segments Advanced Safety and Signal & Power Solutions. A high R&D ratio of over 7%, more than double the industry average, shows their innovation capability. This leads to solutions in autonomous driving and the safety improvements that come with it. Aptiv also benefits from the accelerated electrification trend though their high-voltage interconnects. The company already measures and manages their full carbon footprint including emission outside their direct control and has set a long-term carbon neutrality targets by 2040. These targets are supplemented with intermediate targets of 25% CO_2 reduction by 2025 and 100% renewable sourcing by 2030. Aptive is a prime example of double materiality in climate adaption and therefore ranks highly within our ESG best-in-class investment universe.

Sarasin Sustainability-Matrix®



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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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