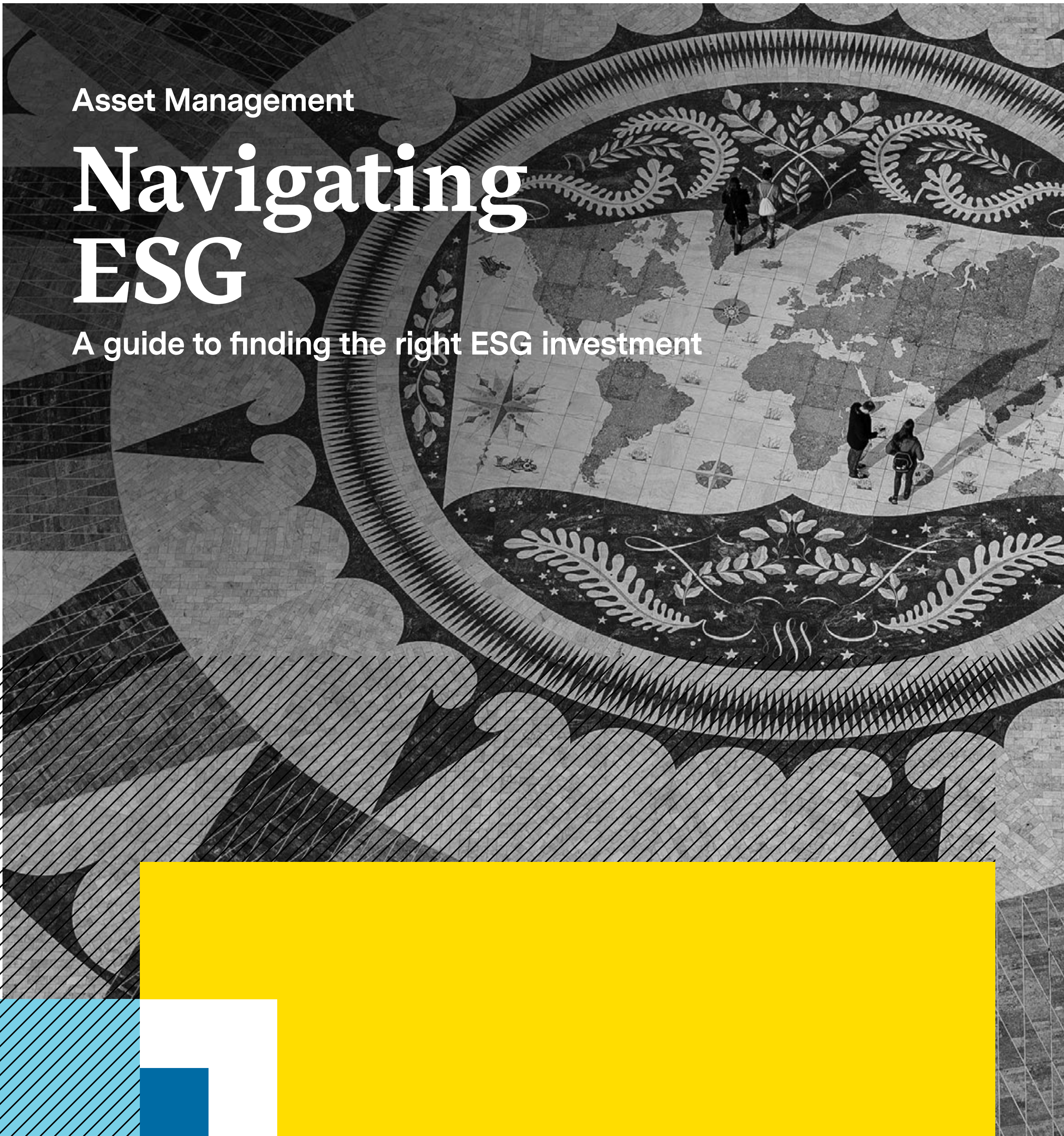
Vontobel

Act ESG



Asset Management

Navigating ESG

A guide to finding the right ESG investment

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Act ESG

What do you believe in?

Act ESG by Vontobel Asset Management signals a discussion on sustainable investing. As ESG becomes mainstream, so too the number of options and approaches increase. For an investor considering a sustainable investment, this document aims to provide a digestible overview of the sustainable landscape, and aims to help you make informed and active choices so that you can pick the right approach based on your needs and beliefs. We start the discussion with a question: What do you believe in?

Why ESG?

Investors have always been concerned about how their money is invested. Although ESG is a recently invented term, referring to the inclusion of environmental, social and governance considerations, ESG can trace its roots back to the Victorian era, when a few philanthropic industrialists realized that their businesses would be more successful if their workers were properly housed and given opportunities for education and healthcare. Since then, ESG has grown into today's diverse range of products and services.

Milestones in ESG development

Individual efforts

1887-1914
Lever Brothers (later Unilever) construct Port Sunlight, a "model village" to house factory workers and improve their welfare through offering education and healthcare

Institutional awareness

1950s
U.S. pension schemes demand that social as well as financial considerations be used to determine investments

1971
Companies disinvest from South Africa in response to Apartheid, following publication of the so-called Sullivan Principles

Initial research and development

1990
First index launched
(Domini 400 Social index, now MSCI KLD400), offering a market-cap weighted index of 400 companies meeting ESG criteria

Mid 1990s
Launch of diversified ESG funds focused on "eco-efficiency" and "best-in-class"

First academic studies on ESG investments emerge, initiating an intense debate

Becoming mainstream

2006
U.N. PRI report defines principles for responsible investment

Law firm Freshfields Bruckhaus Deringer publishes report on the role of ESG when acting in a fiduciary role in seven major investment markets

2014
Law commission in England and Wales confirms that **pension fund trustees may take ESG factors into account** when making investment decisions

Business as usual

2015
U.N. PRI report concludes that "failing to consider all long-term investment value drivers, including ESG issues, is a failure of fiduciary duty"

Academic debate on performance impact concludes that good ESG correlates with good performance

Source: Vontobel Asset Management

ESG investment has gradually developed and will become mainstream, thanks to four factors:

1. Individual investors and institutions desire investments in line with their convictions and values
2. Growing transparency and access to information about how money is invested
3. Evidence that ESG considerations can both increase returns and reduce risks
4. Investor desire to influence how business is conducted

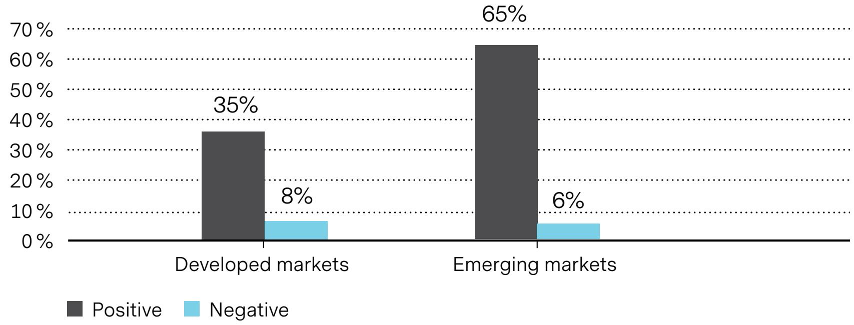
The volume of assets managed according to ESG principles will continue to grow. ESG is not a fad or a fashion, but over the next ten years will become an integral part of how most professional managers think about investment.

How ESG adds value

Between 1990 and 2000 investors thought that inclusion of ESG factors in investment decisions would mean giving up performance. But this thinking is outdated. There is evidence that ESG investments can enhance returns, partly by selecting companies which are better run, and partly by avoiding event-related risks. An extensive meta-review of over 2,000 academic studies on the effect of incorporating ESG factors into investments found strong evidence ESG improves the risk/return profile of investments. Eleven times more studies identified a positive effect than a negative effect for emerging market investments, while the effect was similar but less pronounced for developed markets.

Review of 2,000 academic studies: did incorporation of ESG factors have a positive or negative impact on risk/return?

% of studies



Source: ESG and financial performance: aggregated evidence from more than 2,000 empirical studies (Friede, Busch and Bassen, December 2015)

How does ESG add value?
While the 2,000 studies above considered many aspects of ESG, there are three core ways in which ESG improves investment results:

1.
Increases returns*

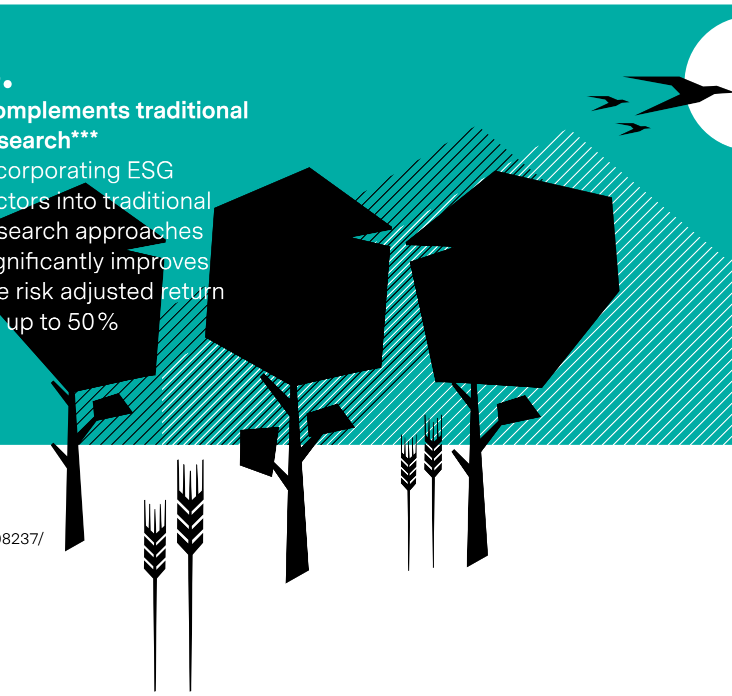
The MSCI World Socially Responsible Index outperformed the MSCI World Index by about 15 percentage points over 10 years

2.
Reduces volatility**

Across almost all categories, equities funds with 5 Morningstar globes (high ESG rating) are significantly less volatile than those with one globe (low ESG rating)

3.
Complements traditional research***

Incorporating ESG factors into traditional research approaches significantly improves the risk adjusted return by up to 50 %



Past performance is not a reliable indicator of current or future performance.

* Vontobel Asset Management analysis as of December 31, 2017
** Categories refer to characteristics of companies such as large, small and mid caps. Morningstar analysis, March 16, 2017. Source: https://www.morningstar.com/articles/798237/sustainability-and-quality-go-hand-in-hand.html
*** Source: Bank of America Merrill Lynch, May 20, 2018. Period of 2005-2017, U.S. equities, BoAML investment universe.

Mapping ESG

What ESG investment approaches are available today?

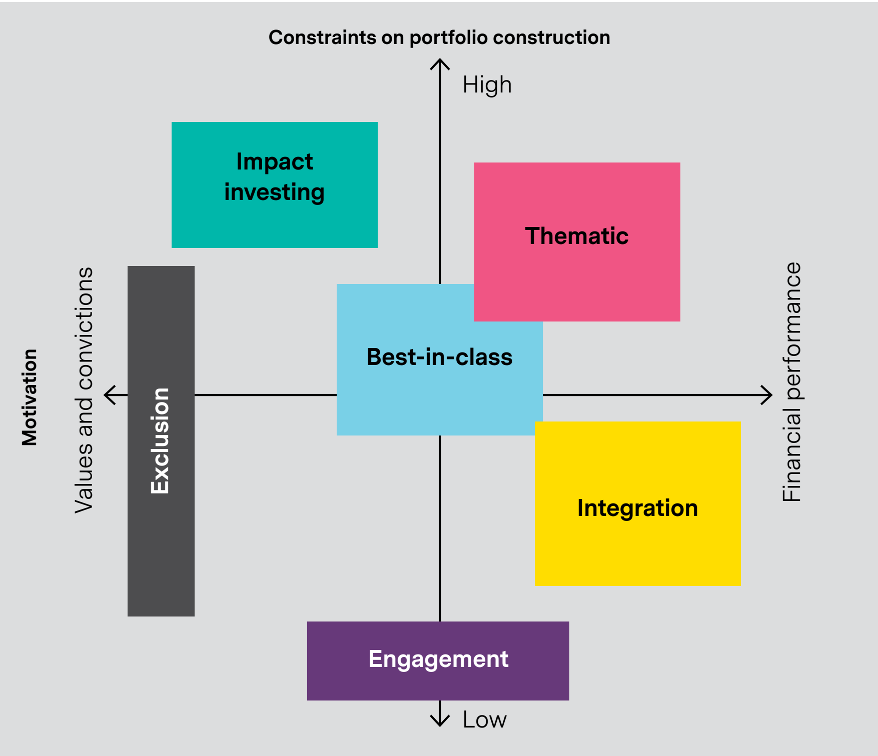
There is a wide range of confusing terminology around ESG today. To avoid confusion, we have defined six categories which we use to describe ESG investments:

Impact investing, thematic, best-in-class, integration, engagement, and exclusion.

We categorise these six ESG investment approaches according to the motivation for the investment approach and the limits it places on portfolio construction. The diagram below maps these differences: on the x-axis we show the typical investor motivation, whether driven by values and conviction, or by financial performance, while the y-axis shows the degree to which the investment approach constrains the portfolio construction.

For instance, Impact investing typically focuses on running specific development projects which deliver improvements in living standards to participants and/or environmental improvements. So we consider Impact investing to have a high impact on portfolio construction, while being motivated by values and convictions, and thus place it in the top left of the chart. The same approach allows us to map the six main ESG approaches in the diagram below.

Investors' motivations and impact on portfolio construction



Source: Vontobel Asset Management

ESG investment approaches

DEFINITION	EXAMPLE AND IMPLICATIONS
Exclusion	
Filtering out undesirable companies or sectors, either based on convictions or on international standards, also known as "norms-based screening". Typically reduces the investment universe at the start of the investment process by removing companies with low ESG scores.	Portfolio excludes companies focused on areas such as armaments or extractive industries to align investments with client convictions. Results in a portfolio of companies which meet ESG minimum standards, but with weightings driven by other factors.
Best-in-class	
Only invests in companies with excellent ESG performance relative to others in their sector, typically by conducting best-in-class screening as the first step of the investment process, often based on external database information.	Portfolio invested in companies with best ESG scores in their sector, rather than moderate ESG performers with other attractive characteristics. Result in a portfolio with additional tracking error due to name-level exclusions. Note that this approach does not exclude segments altogether, e.g. fossil fuels.
Integration	
Includes ESG as a fully integrated element of the investment process, with ESG scorings combined with other factors to support investment decision making, often using a proprietary ESG methodology.	Portfolio invests in the companies with the best blend of ESG and other characteristics. Does not limit the investment universe, but challenging to set up as it requires a purpose-built investment process and portfolio management staff able to conduct ESG alongside other types of investment analysis.
Thematic	
Investment focused on opportunities related to a single theme or megatrend.	Portfolio invested in companies likely to benefit from a disruptive megatrend such as the shift toward cleaner energy. Results in a concentrated portfolio which should perform if the trend develops as expected.
Impact investing	
Investing in activities with a positive impact on the environment or society.	Portfolio focused on one or more areas such as microfinance, renewable energy infrastructure or agricultural development to "do good". Doing good, rather than investment performance is the main focus.
Engagement	
Investors aim to influence company management to improve business practices.	A wide range of engagement levels exist, ranging from proxy voting through to public engagement as practiced by prominent activist funds. May be practiced alongside other equity investment approaches above.

How will my portfolio change if I choose an ESG investment approach?

Most ESG approaches by their nature have an effect on the strategy's investible universe, and thus change the portfolio sector allocation, liquidity and tracking error in comparison with a benchmark. The table below gives an overview of each approach's typical impact. Integration shows little or no impact because the portfolio manager considers ESG factors alongside all other analyses, while engagement has little or no impact on the portfolio because it involves influencing company management, and is often conducted alongside the other ESG approaches.

Application to different asset classes

ESG approaches are now possible in most asset classes, so that the vast majority of typical portfolios can be managed according to ESG standards. ESG solutions covering equities have been available for many years, but solutions covering other asset classes including fixed income and real estate are harder and require additional expertise to apply ESG principles within the asset class. There are also clear limits to ESG approaches due to the nature of the investment and instruments used. For instance, if U.S. issuers of high-yield bonds are mostly energy companies, it's impractical to build a well-diversified ESG portfolio in this segment. Similarly, strategies that invest mainly via derivatives can hardly claim an ESG approach.

How different ESG approaches impact portfolio construction

	EXCLUSION	BEST-IN-CLASS	INTEGRATION	THEMATIC	IMPACT INVESTING	ENGAGEMENT
Impact on universe	↓ Decrease by a few companies to ~10% of universe	ESG + **Investable** - **Not investable**	Full universe available	MSCI World Narrow sub-set of traditional index	MSCI World Typically outside traditional investment universes	Full universe available
Impact on sector allocation	Moderate impact	Moderate impact	No to minimal impact	Large concentrations	Not able to benchmark	No impact
Impact on volatility	In general, ESG approaches reduce volatility through the removal of security-specific risks, but depending on the approach, volatility may rise via higher portfolio concentrations					None
Impact on liquidity	None	None	None	Slight reduction due to small/mid cap bias	Typically illiquid	None
Impact on tracking error	Moderate increase ↗	Moderate increase ↗	Little or no change →	Large increase ↑	Usually no benchmark applicable	No change →

Source: Vontobel Asset Management

How to find the right ESG investment approach?

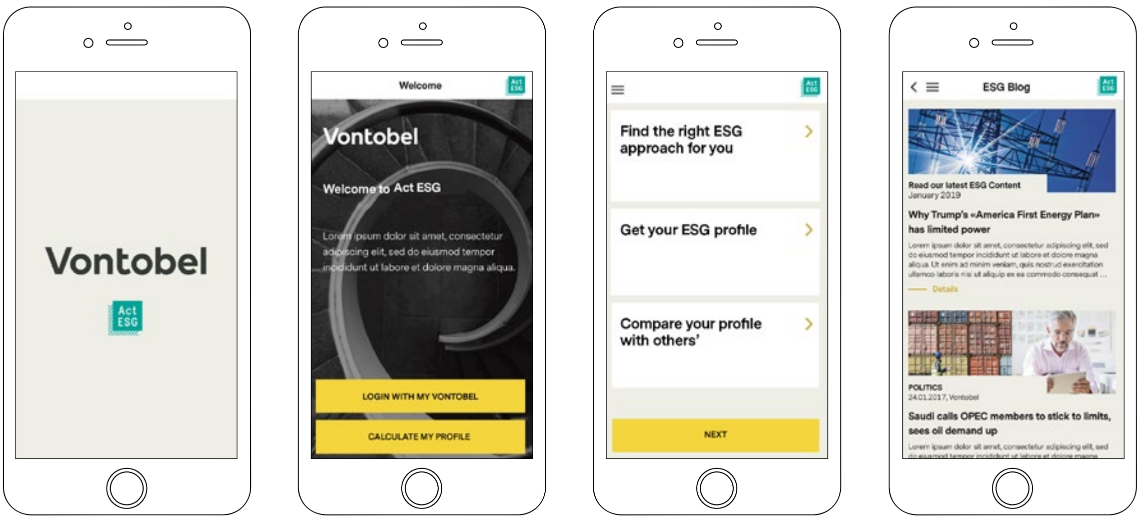
Finding the right ESG approach is not easy and has various implications. We try to guide you through the ESG jungle to identify the ESG approach which makes sense for you, including checking that you are comfortable with its impact on your portfolio. Once these points are clear it's much easier to navigate ESG.

To help you along this journey, Vontobel will shortly launch an "Act ESG" app, which enables you to quickly and easily test different ESG approaches and find the one which is right for you.

Preview:

The Act ESG app

The app will start with a few questions to understand your priorities, and based on your answers, to home in on the ESG approaches which best meet your needs. Once you have built your ESG profile, you can see how this approach to ESG could affect your portfolio, and explore how adjusting your priorities changes the fit of various ESG approaches. Once you're comfortable with the results you will be able to share your profile and compare it with others. Naturally you'll also be able to access Vontobel's ESG-related white papers, insights and other content from the app.



Choosing an ESG asset manager

Choosing the right manager for an ESG investment need not be complex. As well as considering the usual five Ps of investment (philosophy, people, process, performance, price), and other things such as risk management and operations, it's critical to assess the quality of the manager's ESG approach.

This will enable you to screen out the many so-called ESG managers whose approach is superficial, and approach ESG as a simple box-ticking exercise.

There is no substitute for a discussion with the asset manager. Portfolio managers able to give clear and consistent answers to the following six questions in the context of their portfolio, tend to have a solid ESG approach. Or putting it the other way round, you should not work with people who struggle to answer these questions:

Key questions for your potential ESG portfolio manager

1

How does your parent company approach ESG issues?
It is vital that the manager's parent company takes sustainability seriously and incorporates sustainable thinking into how they run all areas of their business. Check the parent company's sustainability reporting and governance structures.

2

What ESG research do you do?
Good managers go beyond buying off-the-shelf ESG research to try to really understand the issues behind the ratings provided by external agencies. Managers should be able to explain what additional research they do and give examples of how they use it in a portfolio context.

3

Were there situations that were challenging from an ESG perspective?
Managers should be able to give examples of how they deal with difficult cases, for example where they chose not to follow a published ESG rating, and discuss companies in depth that are on the borderline for inclusion/exclusion in their portfolio.

4

Explain some of the ESG incidents that occurred in the portfolio?
Managers should be able to explain ESG incidents (environmental problem, supplier problem, etc.) that occurred in their investment universe, then also articulate the financial and risk impact on their portfolio.

5

Are you willing to have an ongoing dialogue on ESG issues?
Because there are no clear standards for ESG, a regular dialogue to discuss issues and market changes is vital to ensure your managers share your philosophy and inform you as their ESG thinking and investment approach develops.

6

What reporting is offered?
Managers should be able to explain their ESG thinking behind their decisions and activities. Managers of funds aiming to make a non-financial contribution should be able to demonstrate their impact in depth.

Sustainability at Vontobel: past and present

Vontobel has a long tradition of corporate responsibility and sustainability. We are a founding member of the Swiss Sustainable Finance association, and have received numerous awards for our sustainable investment funds. The sustainability rating agency ISS-oekom awarded Vontobel the rare "prime" status, and we received an above-average score for the implementation of the U.N. Principles for Responsible Investment (PRI).

Since the 1990s, Vontobel Asset Management has continuously expanded its sustainable investing activities and plays a leading role in this area with 16 billion Swiss francs in assets under management in sustainable investments as of June 30, 2018, positioning Vontobel as the fourth-largest Swiss manager of sustainable assets.

We are active in a wide range of areas and allow our financial experts to apply ESG approaches specific to their asset classes. These comprise global, regional as well as thematic strategies.

To name a few of our sustainable strategies: the Vontobel Fund - mtx Sustainable Emerging Markets Leaders, and the Vontobel Fund - Clean Technology.

Deep expertise
As a multi-boutique manager, each boutique is free to invest according to its own ESG approach. The ESG Investment Committee oversees the architecture of all ESG investment products and determines applicable investment thresholds and criteria, and is responsible for the Vontobel Sustainable Universe. In addition, portfolio managers are supported by an ESG Competence Center comprising six investment professionals fully dedicated to analysing ESG issues.

Act ESG
To support our "Act ESG" watermark, we have built an ESG library bringing together information on our ESG-related standards and policies, so that the documents typically needed to check our ESG credentials are accessible in one place on our website. As well as the ESG library, the Act ESG app contains all of our recent publications on the topic of sustainability.

Results and recognition
We are a founding member of the Swiss Sustainable Finance association and have gained numerous awards for sustainable investment solutions. For the first time in 2018, ISS-oekom rated Vontobel's sustainability performance and awarded it "prime" status. This means that Vontobel Asset Management ranks among the top six percent in its peer group of 44 asset managers worldwide.

Corporate Responsibility Prime
rated by ISS-oekom

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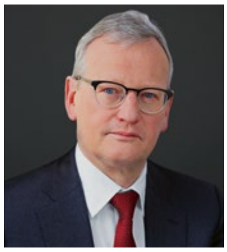

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