For professional clients only

Forward Thinking

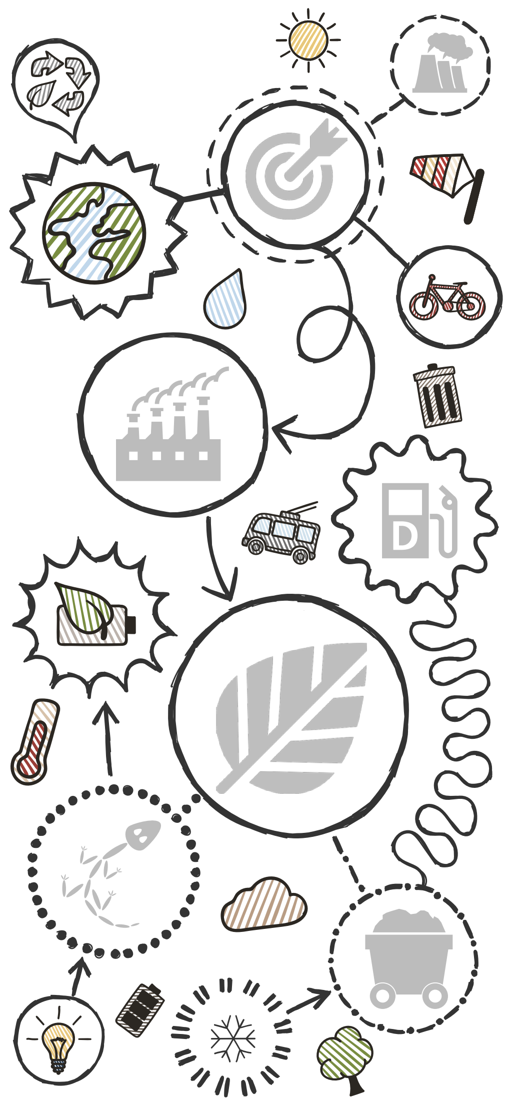
A new climate aware, rules-based equity fund

"The clear and present danger of climate change means we cannot burn our way to prosperity. We already rely too heavily on fossil fuels. We need to find a new, sustainable path to the future we want."

Ban Ki Moon,
Secretary-General of the United Nations 2007 - 2016

Climate aware

It is generally accepted that the world's climate is changing due to rising man-made emissions of greenhouse gases (GHGs), particularly carbon dioxide (CO_2). The largest single source of CO_2 emissions is the combustion of fossil fuels – coal, oil and gas. But how has the global community responded, and what are the implications for investors?



A global reponse

In December 2015, more than 190 nations met in Paris at the Conference of the Parties to the UNFCC, or COP 21. In a landmark agreement, they undertook to strengthen the global climate effort. The Paris Agreement, as it is commonly known, defined the ways in which countries will implement those commitments after 2020. Its objective was to restrict the increase in global average temperature to below 2 degrees Celsius (2°C) above pre-industrial levels, while attempting to ensure that temperature increase is limited to no more than 1.5°C.

The 2°C target considers not just carbon emission reductions. It also involves:

- a transition from fossil fuel related CO_2 emissions to reneweable sources of energy
- a transition path reflected in the reduction rates for GHG emissions over the coming decades

Reaching the Paris Agreement was the culmination of almost 23 years of international efforts by the UN to establish a collective response to the issue of climate change. It was a path marked by failed pledges and ineffectual treaties, with those nations responsible for the greatest emissions refusing to participate. What the Paris Agreement achieved was a legally binding framework.

It has been argued the terms are not perfect – the agreed cap on temperature increase of 2°C has been seen as too loose and many would prefer the cap to have been set at 1.5°C. Nonetheless, it has still been hailed as an important milestone in the efforts to address climate change.

Finding answers

Investment implications

What does climate change and the Paris Agreement mean for investors?

Irrespective of one's views on climate change, the Paris Agreement crystallises it as a key investment risk, bringing climate change, with a focus on carbon reduction, up the agenda. The risks extend across the investment universe, from equities through to corporate bonds, property and, potentially, government bonds.

As a result, many investors are now setting explicit targets for reducing the carbon footprint of their portfolio. Or, to look at it another way, they are targeting the overall long-term transition to a low GHG emission economy.

Clear targets like these also reflect investors' growing desire for their investment policy decisions to have an overall positive impact on society without compromising their mandated goal of wealth generation/preservation. Hence the growing trend towards making sustainable investing practice an integral component of the construction of an investment mandate.

To achieve these increased or decreased exposures, the fund applies a tilt.

A 'negative' tilt is used to reduce the size of the investment in companies such as:

- those that have worse than average GHG emissions when converted to tonnes of CO_2 equivalent
- companies producing energy from coal
- companies with reserves of coal, oil and gas

A 'positive' tilt is used to increase the size of the investment in companies such as:

- those providing renewable energy or supporting technology
- companies performing in line with the globally agreed climate change goals (2°C cap on temperature increase)

This positive tilt also constitutes a differentiator with respect to products that rely only on reducing a portfolio's carbon emission.

Introducing an innovative new solution from UBS

We recognise the magnitude of these potential threats to investors, particularly those institutional investors for whom a reduction in investment values jeopardises the member benefits which they have been mandated to achieve. In response, we have launched the UBS Life Climate Aware World Equity Fund. This innovative new fund is designed to capitalise on the long-term transition to a low GHG emissions economy and invest more in companies at the heart of this transition, as well as those adapting to help provide the future we all want to live in.

This new fund aims to deliver returns broadly in line with the FTSE Developed Index with a target tracking error of +/-0.50%. Our approach allows us to increase or decrease exposure to the index constituents based on their expected contribution to climate change.

Our voting policy

We believe an active voting policy is crucial. Our fund pursues a climate aware voting and engagement policy with companies that most need to adapt their business models in order to meet globally agreed climate change goals.

"At the total portfolio level we aim to broadly follow the risk/return profile of the benchmark. As well as carbon aware constraints, our portfolio construction process also allows relatively low deviations in terms of sector, country, industry, style factors and portfolio beta with respect to the benchmark."

UBS climate aware rules-based portfolio: quantitative and qualitative factors

Our climate aware model in practice

Our model is constructed based on four core elements, or building blocks. These combine to form a multi-dimensional set of metrics that guide the portfolio construction towards a set of exposures that aim to reflect the transition to a low GHG emission economy and the 2°C scenario. Our approach is innovative - it is both forward looking and uses a probabilistic framework to capture the inherent uncertainty surrounding carbon data.

Glide path probability: We build a quantitative model that compares the company's carbon footprint trend with the required emission reduction implied by the 2°C scenario. This approach allows us to estimate the probability that the company will achieve those glide path targets.

Qualitative overlay: We improve the estimates of our quantitative model with a qualitative framework that incorporates information about the company:

- whether carbon emission is reported under the Carbon Disclosure Program (CDP)
- the company's disclosure related to implementation of policies, objectives and/or initiatives related to carbon efficiency

This qualitative data allows us to make a more robust estimate of a company's commitment to carbon reduction. This step is designed to mitigate carbon data quality and reporting issues by introducing related supplemental information on a firm's stated policy.

Current carbon intensity and renewable energy: This relates to current information about direct and indirect carbon footprint (measured as intensity levels). Furthermore, in order to partially capture the substitution of energy sources under the 2°C scenario by clean energy providers, we incorporate information related to both the production of renewable energy and companies offering technology to that sector.

Fossil fuel reserves and energy produced: This element allows the underweighting of companies generating electricity from coal-fired power stations. We also allow the portfolio to reduce exposure to companies that currently hold proven reserves in coal, oil and gas.

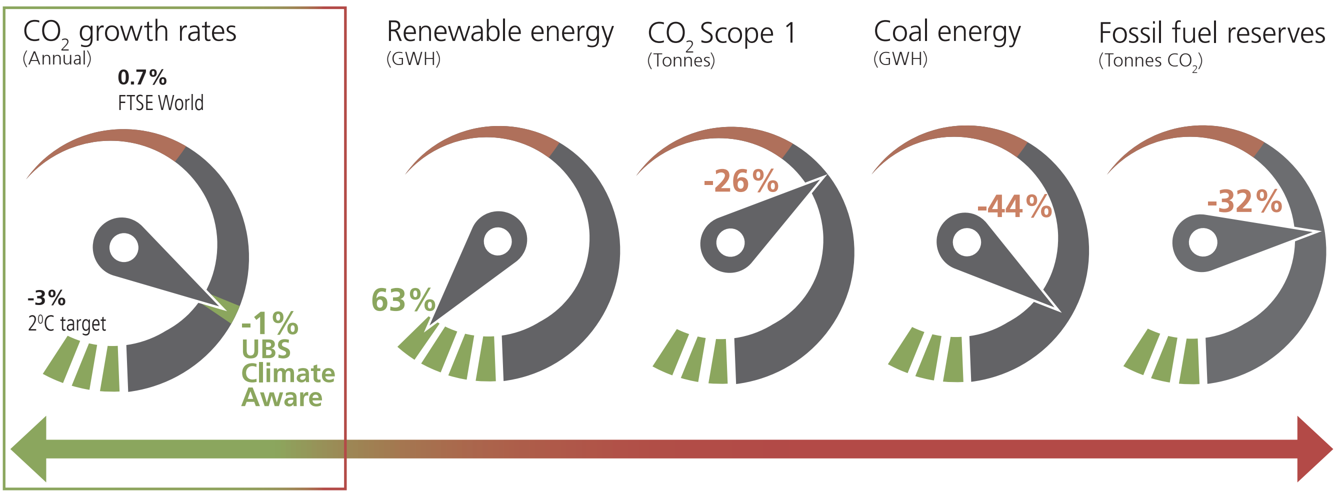
As already mentioned, our approach aims to tackle climate change by including an active voting policy at the general meetings of companies around the world that need to adapt their business, strategy, and corporate governance in order to reduce climate risks and meet globally agreed climate change goals.

We base our climate aware exposures in the context of a range of climate criteria. This includes the three Carbon Intensity Scopes – Carbon Intensity Scope 1, Scope 2 and Scope 3. These are a categorisation of a company's GHG emissions created by the GHG Protocol - the most widely used international accounting tool. Broadly speaking, they can be categorised into direct emissions (Scope 1) or indirect emissions (Scope 2 and 3).

Our simulation suggests that our target climate aware exposures can be achieved with an ex-ante tracking error of 0.28% over the period 2011-2016. Quarterly rebalancing allows the portfolio to control financial and climate-related risk exposures with a modest one-way turnover of 6.8% p.a. on average over the simulations period.

The methodology also allows us to monitor with a level of granularity different relative exposures achieved in our portfolio. Figure 1 shows the exposures in our portfolio.

Figure 1 Selected achieved relative exposures (as of February 2017)



Source: Trucost, Asset4, IEA and UBS Asset Management.[2] In (*) we calculate growth rates as portfolio/benchmark weighted averages of stocks in industry groups related to Climate change. Growth rates are computed over five year time weighted averages. In (**) we consider companies that belong to Renewable Energy Equipment sub-industry group.

In summary

With its innovative and systematic approach to the issue of climate change, the UBS Life Climate Aware World Equity Fund offers investors the opportunity to align their mandated investment targets with their increasing obligations to incorporate sustainable investment factors within their asset allocations.

Why UBS?

- Passive-like deviations vs. benchmark
- Low tracking error and low turnover
- No exclusions policy
- Meaningful carbon reduction
- Aligned to forward-looking carbon reduction targets
- Tilted to renewable energy
- Low cost
- Customisable

Specialist index manager

- Highly experienced, stable and well-resourced team managing index assets for over 30 years, with GBP 175bn index AUM (as at 31 December 2016)
- Robust, proven investment process: strong technology, optimal solution to balance risk and cost
- Big enough to benefit from economies of scale but nimble enough not to face liquidity constraints when trading for index changes

Responsible investor

As a responsible investor, you expect us to take into account environmental, social and governance (ESG) factors wherever appropriate. At UBS Asset Management we are committed to acting as responsible investors on your behalf.

- Signatory to UNEP Finance Initiative and UN Global Compact
- Signatory to UN Principles for Responsible Investing since 2009
- Founding signatory to Carbon Disclosure Project and member of International Corporate Governance Network
- First bank to obtain ISO 14001 certification for worldwide environmental management system in banking business
- Member of FTSE4Good Index series and included in Dow Jones Sustainability Indices
- Signatory to Institutional Investors Group on Climate Change (IIGCC)

If you would like to learn more about the fund and our approach, please contact:

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