BPS (SUISSE)

Striving to achieve increasingly Sustainable Finance

Opinions, considerations and prospects of your trusted Bank

Fourth Newsletter
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Summary

IMPRESSUM

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The evolution of BPS (SUISSE) in the field of the **"sustainability of investments"**

The trend towards greater integration of sustainability criteria into financial advice and asset management continues, although increasing regulatory complexity is creating confusion among both financial service producers and investors.

But how has the demand for sustainable investments behaved during this period? Did complexity and lower-than-expected 2022 performance drive private investors away? It may seem so, but the figures say otherwise.

A recent report compiled by Canadian bank RBC notes that flows from private investors to sustainable investment funds rose in 2023, above what was observed in 2022.

While the topic is received more coolly in the US, in Europe the trend towards flows to sustainable products continues, favouring equity solutions in particular (both active and thematic, as well as passive). What the data also show is greater robustness of Article 9 products according to the SFDR (i.e. with an overtly sustainable objective) compared to Article 8 products (which promote ESG characteristics). In fixed income, however, there is less interest from private clients.

What about in Switzerland? According to statistics published monthly by Swiss Fund Data, the growth of assets under management in Switzerland continues both in absolute terms and as a percentage of total funds: the amount of funds classified as sustainable placed in Switzerland as of October 2023 was CHF 359 billion, or 27% of the total; compared to the October 2020 figure of CHF 251.6 billion, or 20% of the total.

The real change in perception and behaviour can be observed in industry, where regulatory complexity has made the greatest inroads. By way of example, a statistic from Morningstar notes that the number of launches of new sustainable equity funds is at its lowest since 2014 and is down in percentage terms after three years of growth. The series of fund downgrades from Article 9 to Article 8 – which occurred in late 2022 and early 2023 – also testified to asset managers' fears of running afoul of the rules and being accused of greenwashing.

In the Newsletter, we look at the main regulatory topic at the Swiss level, namely the introduction of the SBA Directives regarding sustainability criteria in investment advice as of 01.01.2024.

It will also be interesting to better understand the world of ESG ratings: how do you define whether a security or issuer can be classified as "sustainable"? Should this be analysed using a different technique? Matteo Bosco, partner at Conser, helps us see this from a different perspective. Finally, we analyse with our managers and advisers whether and how sustainability can be considered an investment factor on a quantitative basis and what the different perspectives of thematic equity strategies are.

The Newsletter ends with the usual "Sustainability Snapshots" and confirms that sustainability is a fundamental element of BPS (SUISSE)'s investment strategy.

Thinking sustainable is not just a slogan, but a concrete method of banking and investment management offered by BPS (SUISSE).

Roberto Mastromarchi, CFA, CESGA
Vice President Executive Board,
Head of the Front Office Division BPS (SUISSE)

SUSTAINABILITY WITHIN THE **CONSULTANCY** PROCESS – NEW REGULATORY PROVISIONS

The Swiss financial market is a pioneer of sustainable finance. The concept of sustainable finance describes any form of financial service that, with a view to sustainability, integrates environmental, social impact and company governance criteria (*Environmental*, *Social* and *Governance*, ESG) into business decisions or investment, to the advantage of clients and society in general.

In fact, at a private level, the Swiss financial market has a long tradition within the field of sustainable finance: the first sustainable financial instruments were launched in Switzerland during the 1980s.
The first asset management company to concentrate exclusively on sustainable investments was founded in Switzerland in the 1990s. Swiss financial institutions are among the main global players in the creation of innovative sustainable financial instruments in general and within sustainable finance in particular.

The question of sustainability within the financial sector is becoming ever more important at both national and international levels. For the Swiss financial market, this trend may simultaneously represent both a challenge and an opportunity.

Within this scenario, the State assumes the role of mediator, engaging in close dialogue with the sector and other interested parties, and seeking an optimal regulatory framework.

By contrast, the concept of sustainable finance is quite recent at an institutional level in Switzerland.
On 26 June 2020, the Federal Council published a report and guidelines on the sustainable development of the financial sector. The government set the objective of making our financial sector "one of the leading centres in the world for sustainable financial services". This entails greater transparency in the selection of environmental, social and governance criteria, high accounting standards, and adequate risk management at product level.

"In future, **clients** will be asked to indicate their **ESG preferences**"

On 3 November 2021, FINMA (Swiss Financial Market Supervisory Authority) published a communication (communication 05/2021) on supervision for preventing and combating greenwashing. This concept is configured for when a statement on sustainability contains information that is false or which could deceive consumers, investors and market participants, or when information relevant to their decisions is omitted.

On 28 June 2022, the Swiss Banking Association (ASB) introduced a new self-regulation system into the sustainable finance sector, which provides for new minimum requirements for the integration of sustainability criteria into investment and mortgage consultancy. Specifically, it issued "Directives for financial service providers relating to the inclusion of ESG preferences and risks within investment consultancy and asset management activity", and "Directives for mortgage providers regarding the promotion of energy efficiency".
For the first time, the new Directives establish binding provisions for both the inclusion of ESG criteria within investment consultancy and asset management activity, and for dealing with the subject of energy efficiency in the context of mortgage consultancy.
With regard to directives within a financial context, the legal framework for these is based on the provisions of the Swiss Financial Services Act (FinSA). In future, clients will be asked to indicate their ESG preferences, and products and services provided to them should be in line with these indications. With regard to noting ESG preferences, there are also specific information, documentation and accounting obligations. Financial service providers are also required to integrate ESG matters into training programmes and professional development for their client advisors. Financial service providers make an important contribution to the prevention of greenwashing phenomena through expert advice to clients and transparent information on sustainable investments.
With regard to the Directives within a mortgage context, it should be noted that they provide, in the context of property financing consultancy, for mortgage providers to address the subject of maintaining long-term value when dealing with clients, and therefore also the energy efficiency of the property to be financed. Within the context of property financing consultancy, the subject of the need for anticipated renovation of a building will need to be addressed in the future. Likewise, clients should be informed of incentivisation measures available for the renovation of property, and if targeted technical advice is required, directed to independent specialist centres. Service providers should also ensure that their client advisors regularly engage in professional development relating to maintaining long-term value and the energy efficiency of property.

The new self-regulation rules, which are binding for ASB members, came into effect on 1 January 2023, with various transitional periods to enable the necessary preparations to be implemented.
The ASB thereby strengthens the position of the financial market in the context of sustainable finance, and makes an important contribution towards a sustainable economy.

The Federal Council subsequently adopted the report on a sustainable financial market on 16 December 2022. Through 15 measures for the years 2022–2025, the Swiss financial market is to consolidate its leading position in sustainable finance worldwide.

Further developments within the ESG area at both regulatory and operational levels are to be expected in the future. Despite the encouraging progress made so far, there remains a lot to be explored, and the final objective is still a long way from being achieved.

Lawyer: Alessia Prati Giulieri
President, Head of Legal & Compliance
BPS (SUISSE)

ESG **RATING OR APPROVAL**

Sustainability criteria are becoming increasingly important to many investors, and ESG ratings have consequently become a central point in making these kinds of decisions. However, ratings vary widely among providers. So how can we be sure that the data we use when evaluating our investments really reflect the sustainability we are looking for?
Expert Matteo Bosco has more information.

MATTEO BOSCO
Board Member
Partner of Conser

BIOGRAFIA
Matteo Bosco started out in 1991 in corporate finance for multinationals at Credit Suisse in Zurich and has been active in the financial sector for more than 30 years. From 2000, he managed Credit Suisse's asset management activities in Italy and from 2009 those of Aberdeen Asset Management (now abrdn) in Southern Europe and Switzerland. Since 2017, he has helped to develop Conser ESG Verifier SA, in which he has been a partner since 2019.

Mr Bosco, at the heart of sustainability discussions are the so-called ESG or "Environmental, Social and Governance" criteria. Those wishing to make sustainable investment choices are guided by these criteria. How does an ESG rating provide a reliable indication of whether the company I am considering investing in is truly sustainable?

Ratings provide an independent opinion on the quality of investments. Traditional ratings measure the potential riskiness of the main economic and financial aspects and ESG criteria are added that detect additional elements of risk, environmental, social and corporate governance, which are not always adequately considered in traditional ratings. They provide useful additional information for the investor.

Can you explain why sustainability ratings related to a single company can vary significantly from one rating company to another?

ESG rating companies came into existence at different times, often after a crisis highlighted a need for them. Each has its own characteristics and a different interpretation of sustainability that may not be in line with that of the others.

Mr Bosco, you work for Conser which has developed its own ESG rating methodology.
Can you tell us more about how it works and what consensus means?

Conser was set up in 2007 in Geneva as a specialist in sustainable investments to provide an effective solution to its clients who were confused by the different findings of ESG rating agencies and specialist managers. Conser wanted to take into account the *variety of methodologies and from 2015 developed the ESG Consensus®, which gathers the prevailing qualified market opinion of an issuer's quality. By aggregating these views with other indicators for each security in the portfolio, Conser can provide a robust independent assessment of ESG credibility.*

How does Consensus® fit into the world of ESG rating providers?

ESG rating agencies provide their own valid specialised interpretation of an issuer's quality, which is often used by asset managers as a reference for making investment decisions. Some managers have developed their own internal ratings in order to take into account aspects that are critical to them.

"In the absence of a **common accepted standard**, it is recommended to verify the credibility of a **financial portfolio's sustainability**."

However, in the absence of a common evaluation standard, we need an independent tool that gives the buyer the ability to verify, compare and choose. In this context, Conser has an approved and recognised track record based on collective intelligence.

ESG ratings are based on data released and published by companies. How important is transparency on the part of companies and the publication of a sustainability report?

New technologies used by managers and rating agencies to verify companies' statements include artificial intelligence, geolocation, use of apps, smart devices, satellite images and automated reading of texts published by companies. These companies must be able to demonstrate the truthfulness of their declarations to avoid falling afoul of what is called greenwashing.

You have a great deal of experience in the financial industry. How have you seen the awareness of banks and asset managers evolve in recent years regarding sustainability choices in terms of investments?

Some financial institutions have long stood out due to their attention to sustainability under pressure from their clients, but the general awareness of banks and managers has significantly increased recently as a result of regulation calling for greater transparency and rigour.

Legislators, especially European legislators, are also considering regulating the issuance of ESG ratings in order to standardise them. Do you think this is the right direction to take?

Regulation of rating issuers will be crucial in aspects such as transparency of methodologies and conflicts of interest that may distort their ratings. However, there are conflicting views regarding standardisation that could bring simplifications for investors on the one hand but also diminish analysis on the other.

To sum up, do you think that ESG ratings as we know them today will remain the central tool for sustainability choices?

The legislation requires companies to be more transparent, while new technologies allow them to better evaluate how their declarations align with their activities with regard to real impacts. In this context, rating agencies can maintain their fundamental role as verifiers if they know how to manage their conflicts of interest.

Interviewed by:

Michelle Moro, CESGA
Asset Management, Manager BPS (SUISSE)

FACTOR INVESTING AND **ESG**

In recent years there has been growing investor interest in companies whose business operations are environmentally sustainable, whose relationships with their employees and the communities in which they operate are fair, and whose governance is aligned with universally recognised ethical values. As we know, these behaviours are generally represented by the acronym ESG.

In general, the strategy of systematically selecting investment assets based on the quantitative evaluation of specific characteristics is defined as Factor Investing. Creating an investment portfolio based on the assessment of ESG aspects has given rise to ESG Factor Investing. Given investors' greater attention and awareness of these topics, ESG Factor Investing has recently seen a significant increase in popularity, both in terms of academic research and product offerings.

In addition to satisfying client preferences, incorporating ESG assessments into investment processes is motivated by the theory that these factors have an impact on companies' economic activity and, consequently, on their performance in the financial markets.

For example, from an operational perspective, failure to manage companies' ESG risks could result in adverse events such as environmental disasters, fraud, corruption and lawsuits with employees or consumers. From a financial perspective, ESG management represents an opportunity: investors' preference for companies with high ESG standards ensures a greater flow of capital by reducing its cost. These dynamics have an economic impact on companies' balance sheets, making the best in class more profitable and economically sustainable in the long term.

Any extra-performance generated by ESG factor benefits is called Risk Factor Premium. Empirical evidence on historical data confirms the presence of an ESG Risk Factor Premium for portfolios formed with

securities of companies with high ESG standards. For example, researchers at NYU [1] have demonstrated a positive relationship between the quality of companies' ESG practices and their performance on equities markets in the United States. OECD research [2] expanded the analysis using global data and showed that companies with strong ESG practices tend to have lower stock market volatility and a lower probability of recording extremely negative returns.
There are several methodologies for including ESG criteria in investment processes to try to capture ESG Factor Premium. In top-down methods, the ESG characteristics of securities are quantitatively evaluated and the poorest are excluded; in the bottom-up approach, the portfolio is formed starting with the best in class according to the selected criteria.

"Investors' preference for **companies with high ESG standards** ensures a greater flow of capital by reducing its cost"

However, these methodologies have come under criticism: selecting securities with high ESG standards exposes them to other Risk Factors traditionally known in the literature. For example, studies show that ESG standards have a positive relationship with a company's "profitability" and "quality" (more profitable companies with stronger balance sheets can afford to have higher ESG standards). Thereby, investors, by exposing themselves to the ESG Risk Factor, also expose themselves to "quality" and "profitability" factors.
Given these criticisms, a methodology for accurately quantifying the impact of ESG Risk Premium on equity portfolios was proposed in an article recently published in SSRN [3]. Using an innovative approach, researchers at the University of Zurich put together portfolios with different levels of ESG standards against a benchmark and neutralised collateral exposure to other Risk Factors. This more flexible and controlled approach makes it possible to quantify the real impact of the relatively higher ESG score in relation to the benchmark. The results show that a portfolio with 25% greater ESG Factor exposure than the benchmark (S&P 500) provided significantly higher returns over the period analysed (2013–2022) with consistently lower volatility. This allows for a higher Sharpe Ratio with a low Tracking Error. In other words, the ESG Risk Factor generated a positive (alpha) premium.

Incorporating ESG criteria into portfolio development is becoming critically important for asset managers. They must satisfy the needs of clients who are increasingly attentive to these aspects as they try to maximise performance. These dynamics present themselves as an opportunity: competition supports innovation that drives greater transparency on ESG data and the development of innovative models to achieve more resilient and well-performing portfolios. This leads to benefits for the environment, clients and industry.

[1] T. Whelan et Al, Esg and financial performance: Uncovering the relationship by aggregating evidence from 1,000 plus studies published between 2015-2020, New York: NYU STERN Center for sustainable business.

[2] R. Boffo, R. Patalano, Esg investing: Practices, progress and challenges,2020.

[3] Marc Weibel, Tsuyoshi Iwata, A Factor-Tilt Approach to ESG Investing

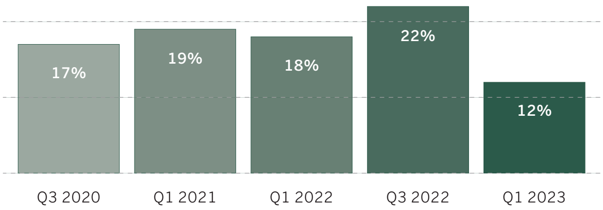
Vito Zaccardo
Portfolio Manager BPS (SUISSE)

ESG TRENDS

After dominating the global landscape in 2023, war and conflict will almost certainly dominate in 2024 and this could test the resolve of markets and investors once again.

This climate of uncertainty, combined with the performance chasing phenomenon that exploded after a disastrous year in 2022, has led to a decline in client interest in ESG, with conversations shifting away from sustainability.

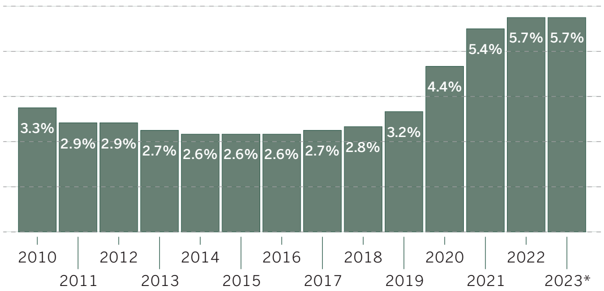
Percentage of conversations with clients in which they raise the issue of sustainable investments



Source: NextWealth

The same phenomenon is confirmed by data on flows directed into sustainable funds, which in 2023 significantly slowed their growth or even decreased, as in the case of launches of new funds.

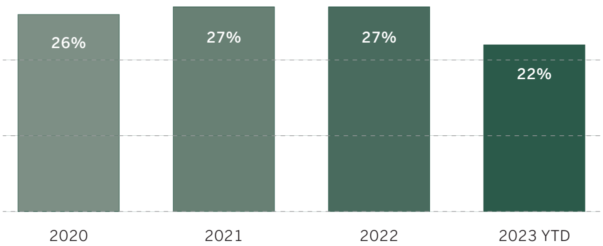
AUM in sustainable funds as a percentage of total AUM in global funds combined between active and passive strategies ($ mn)



* Latest bar is July 2023

Source: RBC – ESG Stat Pack September 2023 Edition

New sustainable funds launched as a percentage of total new launches per year



Source: RBC – ESG Stat Pack September 2023 Edition

United States, could therefore set the stage for another challenging year in 2024 for investments with an environmental, social and governance focus.

For the most optimistic forecasts, the collection of ESG products will therefore remain flat over the next year. In any case, growing the number of ESG investors will require a concrete effort on the part of asset managers, who will need to increase awareness and interest in sustainable investments. The challenge will also be to reconcile the different requirements of regulatory regimes around the world, ensuring that their efforts bring clarity to investors, rather than confusion.

“Growing the number of **ESG investors** will require a concrete effort on the part of asset managers”

There is certainly no shortage of drivers; in fact, from 2024 the following are expected to grow in importance:

Scope 3 emissions are indirect emissions that occur both upstream and downstream in a company’s value chain. These emissions are often more difficult to measure and control than scope 1 and 2 emissions, but they are a significant source of a company’s environmental impact. From next year, pressure will increase to track and reduce such emissions. This will require companies to work closely with suppliers and clients to identify and implement reduction strategies;
The **circular economy** is a production and consumption model that aims to eliminate waste and pollution. It involves designing products that can be easily repaired, reused or recycled, as well as extending product life through maintenance and upgrades. Businesses are expected to increasingly adopt these principles in the coming years, which will result in the development of new products and services designed for circularity, as well as implementation of waste reduction and recycling programmes;
Transition to renewable energy sources, such as wind and solar, is essential to reduce greenhouse gas emissions. Investment in renewable energy and energy efficiency that will mitigate environmental impact and save on energy consumption and costs is definitely a growing trend;
Nature-based solutions are actions that use natural systems to address environmental challenges, such as climate change and biodiversity loss. Examples are tree planting, wetland restoration and forest protection. It is expected that more and more solutions of this type will be adopted by companies, and will be useful for creating social and economic benefits while reducing the impact.

Finally, the shift towards dual materiality should continue in 2024: considering not only the impact of ESG issues on companies, but also the impact of the latter on the environment and society. There is growing awareness among regulators and market participants that only by incorporating both perspectives can the overall sustainability profile of a company be understood.

Marco Guidazzi, CFA, CESGA
Investment Advisory BPS (SUISSE)

SUSTAINABILITY TIPS

Can we really fuel planes with fat and sugar? (source bbc.com: *Can we really fuel planes with fat and sugar?*, BBC Future)
The world's first airliner has successfully crossed the Atlantic using only biofuel. Virgin Atlantic's Boeing 787 was powered not by fossil fuels, but by plant sugars and waste fats, a form of so-called Sustainable Aviation Fuel, or SAF. But not everyone is so sure that this is the future of air travel. The biomass required to produce biofuel can come from a wide range of sources: plant material, food waste or even algae. Biofuel is estimated to emit 70% less CO_2 than conventional fuel. The problem is the sheer volume of biomass needed to feed a fuel-hungry industry such as aviation. An academic paper published in August estimated that 1.25 million square kilometres of land would be needed to grow sugar cane to produce biofuel for commercial jets, roughly equivalent to the surface area of the states of California, Oregon, Washington, Nevada and Louisiana combined. And if you tried to use only waste biomass sources, you would not be able to keep all the world's planes in the air, some experts say. The airline industry is currently responsible for about 3.5% of greenhouse gas emissions, roughly the same as the whole of Japan, which is one of the world's highest emitters.

The climate crisis is not under control; countries' plans do not reduce emissions, but increase them. (source Bloomberg ESG news)
For the UN, the world is losing the battle against the climate crisis. "The problem is not under control. Small actions will not be enough to save us," Secretary-General António Guterres said recently.
The organisation examined the plans of several states to determine their impact. He found that if they were implemented, the planet would still produce 51.6 gigatonnes of greenhouse gas emissions in 2030. Almost 9% more than in 2010.
This is an improvement on the 10.6% identified in the 2022 report, but it is not enough. Just two years ago, at the climate summit in Glasgow, Scotland, states pledged to reduce emissions by 45% by 2030. This would provide an opportunity to stabilise the planet from a global warming perspective. But this goal is becoming increasingly unattainable. Progress is too slow. "The gap between what is needed and what is happening is more worrying than ever," the secretary-general concluded.

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BPS (SUISSE)

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