CIO sustainability scores for issuers

Sustainable investing

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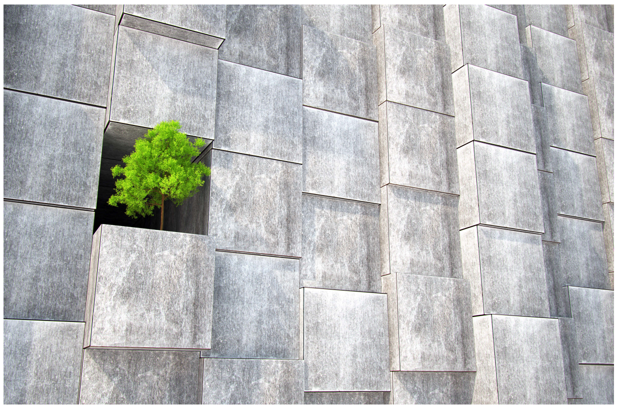
- This paper details improvements and updates to the UBS CIO sustainability scoring methodology for issuers, launched in February 2019.
- The current dataset covers more than 11,000 issuers with over 500 sustainability indicators per issuer sourced from multiple leading data providers.
- The indicators are aggregated into six sustainability topics that go beyond the traditional ESG (environmental, social, governance) framework. This enables investor personalization and preferences to be incorporated into investment advice.
- In this methodology update, we have moved the data normalization process to the very first step of our calculation process in order to ensure consistency across multiple data providers, and different sustainability topics, as well as to further increase score stability. We have also reviewed and updated the degree to which company scores are penalized because of controversial incidents, based on an evolving understanding of this topic.



This report describes our approach to evaluating issuer performance on sustainability topics. It outlines how we aggregate environmental, social and governance (ESG) information to evaluate the sustainability performance of potential investments. While our main focus is the assessment of corporate performance, the approach can also be applied to governments.

Evaluating absolute and relative performance on sustainability topics is not straightforward. Investor views on whether an investment is sustainable or not may vary. Importantly, the process is dynamic. While the sustainability topics and the overarching methodology are intended to be constant, the underlying data points, weightings and inputs will change over time as new information becomes available, issues become more or less relevant and regulation evolves. This report is evidence of that dynamic process, reflecting enhancements made to the methodology since its introduction in early 2019.

Investors today have a wide range of sustainable investing approaches to choose from. Most approaches evaluate the environmental and social footprint of the issuer of a bond or equity in order to determine whether it is a sustainable investment. For instruments such as green bonds or bonds of multilateral development banks, the use of the proceeds also influences whether it is considered sustainable.

There is no universally agreed approach to evaluating corporate sustainability performance, mainly because being "sustainable" is a spectrum, not a binary situation. Sustainability issues are many and varied, affecting companies, people, and geographies to differing extents, and they change over time. There are some widely used frameworks that can help companies decide which sustainability issues to tackle and how to communicate with stakeholders, as well as numerous benchmarks that can help investors compare companies. However, much of the evaluation is subjective and dependent on each stakeholder's priorities. This means that views can vary on whether an investment is sustainable or not—creating uncertainty and confusion among investors who are new to building sustainable investing portfolios.

The accelerated growth of both interest and invested assets in sustainable investing has been followed by growing demand for better data and transparency. Although evaluating sustainability is still subjective, best practice standards have emerged on developing a rigorous methodology that gives a fair review of both the intention and delivery of sustainable outcomes. Our sustainability scoring methodology aims to represent such best practices, and is subject to continued evaluation and iteration to ensure relevance in this evolving space. With these in-house scores, we hope to contribute to informed decision-making by private investors, while navigating and addressing the following challenges:

- *Data quality:* Sourcing data from multiple best-in-class specialized providers results in higher quality and more reliable overall scores. Sourcing the underlying data from multiple sources also allows us to enhance the quality of our scores over time as additional topics come into relevance.
- *Investment applicabilit*y: We believe the six-topic framework provides a simpler, more targeted approach to sustainability for investment decisions.
- *Transparency:* The full transparency of the process offers UBS analysts and investors the opportunity to understand the underlying drivers of the top-line assessment.

In this report we cover:

- Sustainability topics
- Sustainability scoring methodology
- Integration into investment processes
- Key statistics and analysis

We thank Gintare Simkute, Sharon Chan and Sebastian van Winkel for their contributions.

Sustainability topics

We have identified six sustainability topics that encompass the major sustainability challenges that both impact, and are impacted by, corporations and governments. These topics are selected on the basis of industry best practices, relevance to company financial outcomes, data availability and reliability, and client feedback on the issues they care most about. For investors seeking to build a sustainable investment portfolio, we recommend looking for companies that do well at managing these topics.

Five of the topics—pollution and waste, climate change, water, people and governance—focus on how well companies manage these issues within their operations, and therefore reflect the company's operational footprint. The sixth topic—products and services—focuses on whether the company's offering and its supply chain management address sustainability challenges directly, and therefore reflects a more thematic exposure. For instance, an electric vehicle company would be expected to score high on products and services, but might not necessarily score high on climate change given its operations around battery production and life cycle management.

The six-topic framework is designed to offer a more simplified and targeted approach to sustainability challenges, designed specifically to inform the decisions of private investors. In that sense, these topics complement other general sustainability frameworks such as the 17 UN Sustainable Development Goals (SDGs). They represent universal sustainability challenges to all companies, although the priority of each topic differs across industries. Additionally, the companies that manage these topics well are not necessarily those with the least negative environmental or social impact. In fact, sectors with the greatest exposure to sustainability risk factors often have a greater imperative (regulatory or reputation-driven) to work harder to minimize their negative impact.

Figure 1: Description of UBS sustainability topics

Pollution and waste	Companies that have good environment management policies and systems, reduce packaging, recycle materials, manage hazardous waste, limit toxic emissions; and governments that manage their air and land resources well.
Climate change	Companies that manage their carbon footprint and their energy use effectively; and governments that manage energy resources effectively.
Water	Companies and governments that manage their water consumption and resources efficiently and transparently.
People	Companies that retain, develop and promote wellbeing among their employees, encourage diversity and protect human rights throughout their operations; and governments that invest in education and health.
Products and services	Companies that source raw materials responsibly, with strong social and environmental supplier standards, and policies to promote safe and sustainable products; governments that facilitate this through regulation and infrastructure.
Governance	Companies that are fair and transparent on issues such as executive pay, board independence, tax and anti-corruption; and governments that promote strong institutions and rule of law and commit to international treaties on environmental and social issues.

Source: UBS Chief Investment Office GWM, 2021

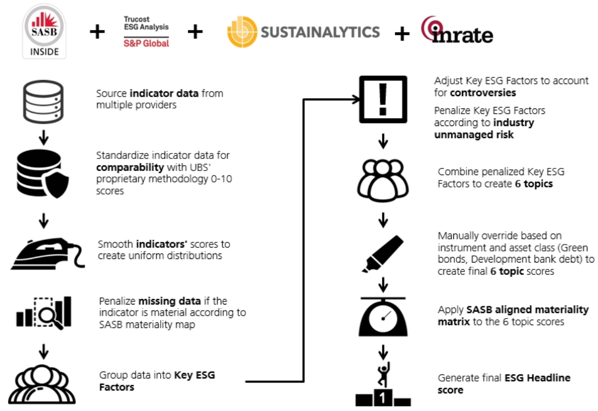
We discuss these topics in greater detail in the final section of this publication, and explore how the management and implementation outcomes of these topics are reflected in our methodology in the coming chapters.

Sustainability scoring methodology

Our proprietary methodology is based on a systematic process of sourcing and processing best-in-class sustainability data, and aligning them to our six-topic framework based on industry best practice. This includes data adjustments and smoothing techniques to make the final scores as useful as possible in an investment context. The approach produces scores from zero to ten for each of the six topics, as well as a final headline zero-to-ten score that reflects a weighted average of individual topic scores based on the topic's importance to each industry, or what we call industry materiality.

We explore select steps within our process in depth in the pages that follow. This is summarized in the following diagram:

Figure 2: Illustrative process of the UBS CIO sustainable investing scoring methodology



Source: UBS Chief Investment Office GWM, 2021

Sourcing ESG indicators

Our database of over 500 ESG indicators is sourced from multiple best-in class sustainability data providers chosen based on their area of expertise, covering nearly 11,000 equity and bond issuers and 170 countries. These indicators evaluate how a company manages ESG risks and opportunities, economic prospects, and potential reputational risks. Our current data providers are Sustainalytics, Trucost, and InRate. We also license SASB's industry classification system (SICS) and materiality matrix. We expect to add additional specialized providers with expertise in different sustainability topics.

We also source indicators on actual controversies such as instances where companies have breached international norms (e.g. the UN Global Compact) or governments have breached UN, US or EU sanctions, or face any other ESG-related events that may affect their prosperity and economic development.

Normalizing for comparability

The indicators are normalized in order to arrive at a score between zero and ten, to achieve comparability between different providers, smooth the score distribution, create higher score stability, and enable comparability across different indicators and topics. We preserve the worst and best scores, zero and ten, for each indicator, but otherwise normalize all other raw data for all indicators. This is a change from our initial methodology where normalization happened later on in the process, at key ESG factor level, which works well when working with single sources of indicators, but increases complexity in multi-vendor approaches.

Penalizing missing indicators

For investors, the absence of information can be as much of a risk to the investment case as a low score that indicates poor management of an issue. It is important to distinguish between indicator gaps caused by inadequate disclosure or poor performance and those that are a function of business model irrelevance.
Missing indicators are assessed based on: (i) how important this data point is in reflecting industry challenges, for which we use the Sustainability Accounting Standards Board (SASB) Materiality matrix; and (ii) whether the data is disclosed by at least 40% of industry peers. If both of these hold true, then we consider this indicator as relevant and a score of zero is assigned for non-disclosure. If the indicator is not relevant according to the criteria, it is removed from the score calculation.

The SASB Materiality matrix identifies the sustainability issues that impact value creation and financial performance for industries based on the SASB Industry Classification System (SICS), and the 40% threshold is based on current industry norms.

This step ensures that companies that are lagging their peers in transparency on common issues are penalized, whilst accepting disclosure omission based on business model irrelevance.

Applying the six-topic framework

The 500+ ESG indicators are grouped and mapped into 17 key ESG factors, on equal weighted averages. Key ESG factors offer additional granularity within the six topics, enabling us to better understand the underlying sustainability issues that driving sustainability performance.

Accounting for risk

We penalize scores based on two main areas of risk: controversies and unmanaged risk.

Controversies are significant both as a source of risk in its own right, as well as reflecting discrepancies between what an issuer might say in terms of policies in place, and actual implementation. We factor in controversies such as breaches of international norms like the Universal Declaration of Human Rights, the ILO Declaration on Fundamental Principles and Rights at Work, and the UN Global Compact, among others. There are five different levels of controversies from zero (no controversy) to five (severe) which reflect the severity of the event's impact, and can range from a small policy breach to large fines, significant costs, and reputational damage. We use penalization factors to account for these controversies, and review them annually as part of a broader methodology analysis.

Unmanaged ESG risks are those that are material and cannot be managed by a company through its internal policies or programs. For example, given the state of innovation today, an airline company cannot avoid the use of fossil fuels, and therefore has a structural risk related to carbon emissions. We source Sustainalytics estimates on severity of the risk based on industry.

Scoring the six topics

Each of the issuer's six topic scores is an equally weighted average of the penalized key ESG factor scores that are relevant for the particular topic.

Recognizing that some securities are specifically designed for sustainable investing purposes, we apply an additional set of rules for green bonds and multi-lateral development bank bonds:

- *Green bonds*: Given their positive contribution to climate change, if the climate change score for issuers of green bonds is less than nine, we apply a manual override to set this topic score to nine.
- *Multilateral development banks (MDBs)*: given their positive contribution to the UN SDGs through their financing, the products and services topic, if an MDB's calculated score is lower than nine we manually override it to nine.

Weighting on topics' materiality for a headline score

Reflecting the industry's best practices, the six topic scores are weighted based on the perceived relevance to company financials of each topic for each industry as identified by the SASB Materiality matrix. This results in a single headline sustainability score for each issuer, ranging from zero (least sustainable) to ten (most sustainable). This score is absolute and not relative to industry peers.

Integration into investment processes

The design of our sustainability scoring methodology is intended to be global and dynamic. The headline scores represent the company's positioning based on current available indicators. These scores are likely to evolve as corporate behavior shifts, for example on disclosure policy. As such, our headline scores are designed to be integrated into a holistic investment analysis process, instead of viewed as a standalone metric.

For example, while considering corporate financial information and regional and sectoral drivers, investors can use the sustainability scores to help identify potential ESG-related risks or opportunities that were not apparent from the financial analysis. Investors could also use the scores to assess the sustainability profile of their portfolios to better understand their exposure to potential sustainability risks and opportunities, as well as to evaluate whether their investments are aligned with their personal values and interests. To help with the latter, we also source specific information on the type of business activities that a company is involved in. We source indicators on whether companies are involved in a range of activities that some investors may consider unacceptable in a sustainable investing portfolio and hence would like to exclude. Figure 3 shows some examples of the exclusion activities available in our methodology.

Figure 3: Selected exclusions and illustrative investor preference

Controversial business activities	Your preference
Adult entertainment	☐
Alcohol	☐
Weapons	☐
Gambling	☐
Genetically modified organisms	☐
Nuclear power	☐
Thermal coal	☐
Tobacco	☐

Source: UBS Chief Investment Office GWM, 2021

Key statistics and analysis

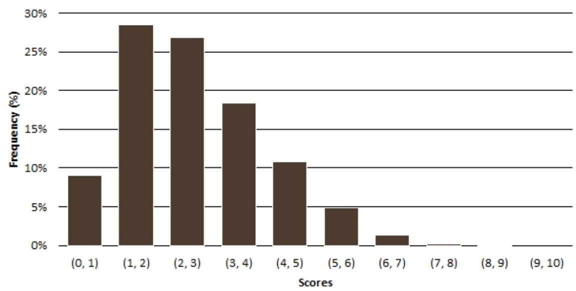
In this section, we provide a high level analysis of the key score distributions and some insight into how companies in different sectors perform. We also provide a brief explanation of how to interpret each of the topic scores.

Overall score distribution

The score distribution for the full assessed universe across the six topics is typical for sustainability scores (illustrated in figure 4). Companies that score zero are considered to have poor ESG practices and those with higher scores are companies that do better.

In looking at the overall distribution of scores in the entire universe, we observe that companies tend to score higher in environmental topics than in social ones. This can partially be explained by the history of sustainability reporting which originally focused only on the physical environment and gradually expanded to consider social issues. Products and services is the lowest scoring topic and represents the small percentage of companies that offer products and services that help solve the challenges outlined by the UN SDGs.

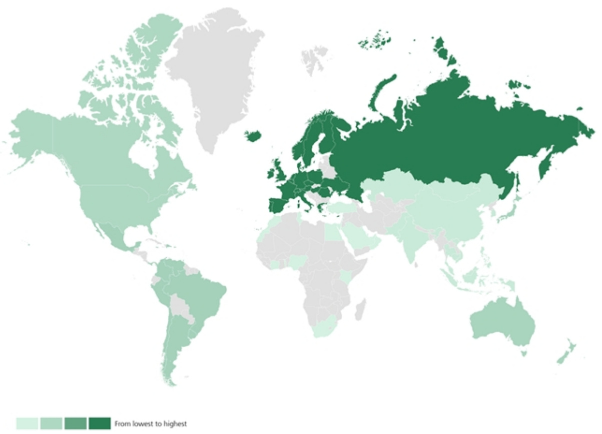
Figure 4: Histogram of corporate and development bank headline scores – full assessed universe



Source: UBS Chief Investment Office GWM, 2021

Unsurprisingly, the highest scores are found in developed markets where the societal trends and regulation already encourage greater transparency. Global investors need to be aware of this potential bias in the data and factor it into their portfolio diversification and risk management decisions. Investors focused on regions with low scores and low transparency may need to spend more time on qualitative fundamental research to compensate for the lack of standardized ESG disclosure.

Figure 5: Average headline scores, by region



Source: UBS Chief Investment Office GWM, 2021

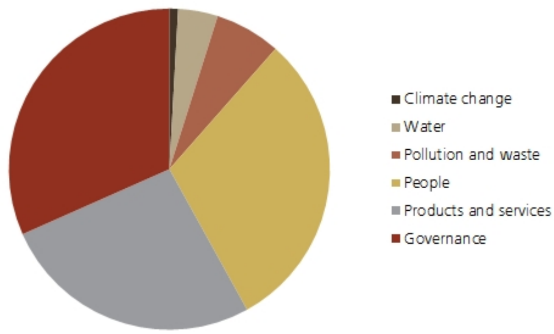
Controversies

Data on controversies is an important element of a sustainability assessment as it provides insight into whether companies are actually putting sustainability policies into practice.

The topic most frequently impacted by controversies is governance, with corruption and bribery breaches being the most common. Adjusting companies' scores to account for such controversies helps ensure that our score reflects not only the presence of anti-corruption and anti-bribery policies and trainings, but also how well entrenched these are in a company's internal controls and in practices. Products and services is also subject to potential controversies, driven by breaches in responsible production and sourcing includes those related to supply chain management, quality management systems and eco-design. Supply chains are becoming increasingly complex, and as consumers become more environmentally and socially conscious they expect companies to manage their supply chains responsibly.

The topic least frequently impacted is climate change. Climate change is a broad and complex topic and it is not easy to attribute a controversy to a company as long as the company operates in accordance with local environmental laws. Nonetheless, more frequent climate change related controversies are emerging as climate-related regulation develops and stakeholders scrutinize company behavior in more depth.

Figure 6: Frequency of controversies across the six topics



Source: UBS Chief Investment Office GWM, 2021

Understanding the six topics

Pollution and waste

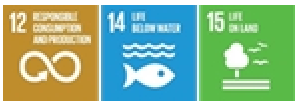
The pollution and waste score aims to capture how effective a company's strategy is at managing air pollution (nitrogen oxide, sulfur oxide, particulate matter and volatile compounds), noise, hazardous waste, and its land and biodiversity impacts.

An increasingly stringent regulatory environment for managing waste places responsibility on the producers (i.e., companies) to bear the cost of managing and disposing of waste products throughout the value chain, not only within their factory gates. For some companies, particularly those that use specialist or hazardous materials, this can present an enormous cost and a potential risk.

High scoring companies or industries are those with appropriate management systems in place and are not necessarily those with the lowest pollution and waste intensity. Simply comparing absolute pollution and water footprint would favor service orientated companies over their industrial counterparts. For this reason, we also consider management processes. Negative impacts could include reputational damage, fines and new regulations. Positive impacts could include the benefits of a circular economy that reduces waste and uses recycled materials.

This topic is most significant to manufacturing companies in sectors such as industrials and materials, as well as utilities and businesses involved in transportation or infrastructure development. Companies in these industries that receive high scores on sustainability scorecards may be doing well in managing the pollution risks inherent in their sector. This topic is less significant to service-oriented companies such as those in the financial, IT, and communication services sectors. For such companies, pollution and waste risks should be easier to manage.

Related UN SDGs:



Climate change

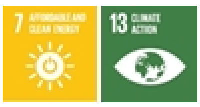
The climate change score aims to capture how well a company manages its climate change risks and/or opportunities. It is not limited to reflecting a company's or industry's carbon footprint or intensity.

The Paris Agreement, an accord signed by 175 countries to limit the rise in the average global temperature to less than 2 degrees centigrade, came into effect at the end of 2016. However, to achieve this target, which many believe to be ambitious, widespread and immediate changes in energy consumption patterns such as usage and sourcing are needed to reduce emissions of carbon dioxide (the primary contributor to climate change) and other greenhouse gases (GHGs).

For this reason, high scoring sectors or companies are not necessarily those with low emissions. Instead, companies that derive a competitive advantage from accurately managing their climate strategy score highly.

This topic is most significant to the energy, industrials, and utilities sectors. In particular, the oil and gas, transportation, and aerospace industries contribute most significantly to GHG emissions, though some companies have made significant progress in managing their carbon footprint. Healthcare and consumer and business service industries tend to have the least risk exposure to this topic.

Related UN SDGs:



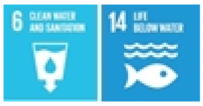
Water

The water score reflects how much water a company or industry consumes, its consumption trend over the last three years and how transparently it reports it.

While policies on water use are often made by governments, corporations are major consumers, affecting the communities around them. In many industries, water is a key input to production; therefore, water intensive industries could face large operational risks if there is a scarcity. High scoring companies or sectors will be those that use less water relative to their revenues and low scoring companies those that use more water relative to revenues.

This topic is most significant for the utilities and consumer staples sectors, especially the food and beverage and household products industries. Companies in these sectors tend to have very high water consumption. Companies in the financial, information technology, and communication services sectors use relatively little water, so this is not usually a high-risk topic for them.

Related UN SDGs:



People

The people score represents the extent to which a company takes care of its employees by advancing employee welfare and encouraging diversity across the organization, protects human rights throughout its operations and protects data privacy and security.

Poor handling of social issues can have a more rapid impact on a company’s productivity or profitability than some environmental problems. For example, high employee turnover will have an immediate effect on costs. Companies that are found to be engaging in workforce abuses, even inadvertently, can suffer severe negative reputational impact. There is strong evidence that well managed and diverse workforces can contribute to, or at least are correlated with, better profitability.

Consistent and comparable data on social issues is harder to find than environmental data. Some data is available from corporate disclosures, particularly where there are regulatory requirements for disclosure of workforce health and safety or diversity metrics. Often the most useful information comes from third-party sources such as the news, internet job platforms, and general industry websites.

This topic is especially significant to industries in which knowledge is the core competency, such as financial, information technology, and business services, as well as the consumer discretionary industries that tend to have large and diverse consumer-facing workforces.

For manufacturing and capital goods industries, people-related issues tend to be less significant than environmental issues.

Related UN SDGs:

Products and services

The products and services topic differs from the other sustainability topics in that it considers whether a company's core business—its products and services—actually contributes positively to sustainable development and are sourced responsibly. The types of products that are generally considered sustainable include those related to renewable energy, efficiently managed natural resources, energy efficiency, sustainable agriculture, education, and green and affordable housing. The products and services score has two main components: revenue exposure to sustainable products and services and evidence of responsible production and sourcing.

Industries that develop solutions to sustainability challenges, and companies exposed to these industries, are expected to grow the fastest in the coming years. Even in industries where products and services seem already linked to sustainability, consumers are demanding more eco-friendly products.

While sustainable products provide an opportunity for companies, managing ESG issues in the supply chain is mostly a part of risk management.

High scoring companies or sectors will be those offering products and services that help achieve the UN SDGs while being responsibly sourced and produced. Development banks lead given their positive contribution to the SDGs through their financing. The worse performing sectors are tobacco, drug retailers, and mortgage finance.

Industries that face the greatest environmental challenges are often best placed to develop sustainable products and services, such as utilities companies developing renewable energy, and materials companies developing less resource-intensive chemicals.

The information technology and communications industries are also well-placed to develop services that help solve sustainability challenges. Consumer industries with complex supply chains are most exposed to risks stemming from this topic.

Related UN SDGs:

Governance

Corporate governance is often considered to be the starting point for managing all forms of risk. Best practices in corporate governance are well established and, in many countries, enshrined in regulation or voluntary codes. Stock exchanges play a role in maintaining a minimum standard of good governance and reporting in order to allow companies to raise capital through public markets.

Corporate governance is a critical issue for investors not only because a well-managed company is more likely to be a good investment, but also because it ensures that the interests of shareholders and management are aligned, shareholders are treated equally, and the rights of minority owners are protected. Corporate boards are coming under increasing scrutiny, and many aspects of governance are regulated through both compulsory and voluntary codes.

Companies scoring high on governance will be those with adequate checks and balances for their board of directors, fair pay for performance compensation schemes for their executives, and strong practices relating to tax and anti-corruption. Governance is a significant topic for all companies regardless of sector, but governance practices can vary widely between regions depending on local cultural norms and regulatory requirements.

Related UN SDGs:

Appendix

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