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The Growing Sophistication of ESG Investing

Pension Funds Rolling Up Their Sleeves to Tackle ESG

Extending ESG across the Asset Spectrum

Pressure Mounts to Standardize ESG Data Reporting

Engaging the Passive Investor

The 2°C Challenge

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nce considered an afterthought or just nice to have, environmental, social and governance (ESG) factors have become a standard part of the investment process for active investors and, more and more, for passive investors as well.

"Increasingly in the institutional space, there’s a recognition that ESG integration helps improve the portfolio management process and can diminish risk within passive investing," said Bruno Bertocci, head of the Sustainable Investors Team at UBS Asset Management.

That said, just what asset owners and managers regard as ESG factors isn’t always clear.

"As an industry we’ve put a lot under the ESG umbrella, which makes it hard for investors to understand what the outcomes are and should be," said Jessica Ground, global head of stewardship at Schroder Investment Management. "The most important idea to understand about ESG today is that it is about integration and engagement, not simply exclusion."

It’s partly a problem of terminology. ESG sometimes gets lumped in with what many consider a broader category, that of responsible investing.

**NO CONSENSUS**

"Responsible investing — for the large asset owner — means ensuring an efficient return for the level of risk from a strategy," said John Streur, president and chief executive officer of Calvert Research and Management. "Responsible investing is larger than simply ESG."

While Streur thinks that most investors would agree with the larger definition of responsible investing, he said the investment industry is far from a consensus on understanding environmental and social performance, and governance structures.

"As well as being an important part of our investment process, ESG integration is an effective building block for different investment solutions," said Ground. "The most extensive is responsible investing, meaning investing in the most sustainable companies, those that are following the right policies over the long term."

"We define ESG investing as the integration of additional information regarding environmental and social considerations and data into the investment process," said Hannah Skeates, senior director for strategy and ESG indices at S&P Dow Jones Indices. "This is a data set that is growing constantly."

At ClearBridge Investments, Mary Jane McQuillen, a managing director and portfolio manager, has identified several different interpretations of ESG investing. One minimal interpretation is to consider only screening and no integration into the investment analysis.

More advanced approaches include asking an investment manager to demonstrate experience in managing responsible investment portfolios over a number of years and evidence of associated competitive performance history. Increasingly, asset owners are asking managers to show certain intentionality with regard to
their environmental, social and governance objectives, in the form of active engagement or impact measurement.

While ESG considerations feature strongly, Streur pointed to two other important — and often overlooked — aspects of responsible investing: corporate engagement, which ranges from proxy voting to direct engagement with companies and issuers of securities, and impact reporting, which uses key indicators and metrics to benchmark social and environmental impact.

While much of the effort to identify and quantify ESG effects is focused on devising metrics, scores and benchmarks, just having the information isn’t enough.

**FINANCIAL MATERIALITY**

“We don’t see ESG investing as a superficial investment overlay or add-on,” said ClearBridge’s McQuillen. “For us, it involves integrating the material and relevant ESG factors into our fundamental research and stock selection process.”

“What people want to understand, when they have a lot of information on a company’s ESG performance and stewardship, is how does this relate to the company’s return on invested capital, its earning potential, and its future risks,” Calvert’s Streur added.

Indeed, the issue of the financial materiality of ESG metrics is climbing higher on investor agendas.

In describing how ESG factors are taken into account by managers looking to value a specific company, Schroders’ Ground cited how a company treats its stakeholders — customers, employees and suppliers — as a starting point.

“This will be different in every company and every industry, so we will consider the impact of this factor on the valuation,” she said.

“The challenge with ESG investing is that while managers have financial algorithms galore, very few are looking at the ESG data in a systematic and rigorous way,” Ground added. “We don’t think of this analysis as a burden because it can give you a much fuller picture of how companies are actually performing.”

When it comes to environmental issues, the information is very industry-specific. In industries that use a lot of water, are material-intensive or produce significant environmental waste, those are the issues companies must manage carefully and those are likely to have different weightings.

Still, the ability to identify the different factors that relate to environmental, social and governance issues is important.

“Some investors may look at all of ESG bundled together,” S&P DJI’s Skeates said. “Some will have a particular interest such as low carbon. We think that it is a reflection of the sophistication of the market that you can combine an ESG element like governance and a factor such as quality, as we do in our LongTerm Value Creation index.”

Often managers judge governance by a number of hard metrics, such as whether the company has separate CEO and board chair roles, appropriate pay policies or a diverse board. But making a true judgment also requires having an opinion about the stewardship of the company.

“Equities are permanent capital, so equity holders have a responsibility to understand the future direction of the company,” Schroders’ Ground said. “We look for good boards that are not complacent and challenge their management about the future.”

“Good governance means being transparent,” added ClearBridge’s McQuillen. “It means being accessible.”

Where shareholders want to see that transparency in governance is around decision-making, and how capital is allocated is a key topic on which investors value more information.

“How did the board decide on the share buybacks, the merger, the dividend distribution and also importantly, executive compensation and management target-setting in a sustainable way?” McQuillen said.

The changing way managers and investors think about ESG investing is a marked contrast to just five years ago, when, according to Ground, institutional investors were most focused on governance issues — proxy voting, for instance — while environmental and social concerns were somewhat of an afterthought. Even today, she said, governance and environmental issues take up more time than the social ones.

“Many pension funds start by looking at the governance aspects because these are more obvious,” said UBS Asset Management’s Bertocci. “They have seen the successes of activist investors.”

After funds reach that level of engagement, it can be easier to make the case for other aspects of sustainability with the investment committee and internal staff. •
Just a few years ago, most institutional investors were not engaged with ESG issues in their portfolios. Today, they are more engaged than ever.

Some are moving beyond just considering issues. John Streur, president and chief executive officer of Calvert Research and Management, said several large asset owners are developing internal capabilities and hiring staff. Consultants are getting in on the act as well, devising ESG scoring and assembling discrete capabilities.

Large pension funds, endowments and foundations are pushing toward integrating ESG considerations and metrics throughout their portfolios. If they have a strategic allocation that is based around asset classes, they are pushing their existing managers to broaden their investment criteria to include ESG metrics.

However, U.S. pension funds lag those in Europe, Asia and Canada when it comes to the importance of ESG issues in investment strategies, according to a Schroders study. Just 21% of U.S. plans incorporate ESG factors into their investment strategy, in contrast to 58% in the U.K. and Europe, 37% in the Asia-Pacific region and 52% in Canada.

It’s all about integration.

EXTERNAL VALIDATION

“I don’t know of any large fund that has a separate sustainable allocation,” said Bruno Bertocci, head of the Sustainable Investors Team at UBS Asset Management. “RFPs ask for global managers or U.S. managers with sustainable expertise.”

Often that means asking for external validation. “I can’t think of the last RFP that didn’t ask if we were a signatory to the UN [Principles for Responsible Investment],” said Jessica Ground, global head of stewardship at Schroder Investment Management. “Now they also want our PRI assessment score and transparency report.”

The PRI Association provides assessments that score managers on the evidence of their sustainability efforts and process in a variety of asset classes.

“We do find asset owners asking to see our UN PRI audit,” concurred Bertocci.

Asset owners expect proof across all aspects of ESG activity. “Five years ago, it was enough to say to our clients that we considered ESG factors,” Ground said. “Now they want us to show them what we are doing. They say, ‘We want to know which companies you have engaged with and where you effected change.’ They are holding us to much higher account.”

“Our clients expect us to vote proxies and not only just to vote, but to take an active interest in the issues and engage companies when we think that our clients’ best interests are not being taken care of,” said Bertocci.

CONSTRUCTIVE DIALOGUE

For years, managers have been working together with other managers and beneficial owners to discuss proxy voting proposals and which issues need to be raised to the company.

“It is a constructive dialogue,” said Mary Jane McQuillen, a managing director and portfolio manager at ClearBridge Investments. “If we see a new shareholder proposal, we want to understand why the proponent filed it and if the request has merit. Sometimes through the dialogue, that proposal is withdrawn because the issue is addressed. That can be a success.”

Schroders’ Ground suggested that the clients with the greatest appetite for information are sovereign wealth funds, although she expects that other investors will follow their lead. And she said that investors of all types are looking for climate change disclosure.

Investment committees have a wide range of experience with ESG investing. Some are far along the educational curve, have engaged a consultant to work with them on a sophisticated approach to the subject, and are using well-thought-out criteria to implement an ESG strategy. Others take what they may think is a simple and safe approach to the subject, by limiting their efforts to one theme such as carbon.

“The ramifications of such an approach may inhibit the fulfilment of the investment goals,” McQuillen said. “We think that as fiduciaries, institutional investors need to consider these societal issues as long-term investors and generate an approach internally, rather than simply reacting to events.” •
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Responsible investing can be applied to alternatives, real assets

While most investors think of ESG investing as an equity consideration, it’s an approach that can be applied to other asset classes. Jessica Ground, global head of stewardship at Schroder Investment Management, said ESG can be relatively easily extended from equities to bonds.

“This is an extension of a discussion of risk,” she said. Credit investors use many of the same tools as their equity counterparts, while social factors can impact the performance of sovereign emerging-market debt.

As the investment industry becomes more effective at assessing companies for ESG factors, it’s also becoming more important to apply this expertise to other asset classes, such as bank loans, small-cap equities, municipal bonds and asset-backed securities, said John Streur, president and chief executive officer of Calvert Research and Management.

But investors in various asset classes are already considering factors that are part of ESG. When it comes to real assets, for instance, ESG has long been a feature of project assessment. In real estate, owners are well aware of the need to consider issues such as water and energy usage, and this information is quite commonly available to investors in directly funded projects, as well as real estate investment trusts.

WORTH MORE

“Property investors know that efficient, green buildings are worth more,” said Bruno Bertocci, head of the Sustainable Investors Team at UBS Asset Management. “Similarly, some infrastructure projects are specifically sustainability-focused, such as solar panel and wind generation farms.”

“We get questions around what ESG indices exist in all asset classes,” said Hannah Skeates, senior director for strategy and ESG indices at S&P Dow Jones Indices. “What we can provide is a benchmark that may be based on a factor, a theme or an asset class.

“Most investors start with broad equity indices and think about how to integrate ESG in general, or through low carbon indices or fossil-fuel-aware indices. An example would be the...
Emerging-market investments provide a particular challenge to managers. When it comes to judging ESG issues, there’s a big difference between emerging markets and nearly developed markets, such as Taiwan or Korea, where both accounting and sustainability disclosure standards are quite good.

Analysts find it easy to compare Samsung and Taiwan Semiconductor with developed market rivals, for instance. But further afield, according to Bruno Bertocci, head of the Sustainable Investors Team at UBS Asset Management, “you’re going to get a lot less data.” Having analysts who are based in emerging nations can bolster the information available, but it does present a greater challenge.

While emerging markets are rarely a significant allocation for institutional investors, “we see them as an emerging opportunity for investors,” said Mary Jane McQuillen, a managing director and portfolio manager at ClearBridge Investments. “But transparency is a paramount consideration here.”

Specifically, she looks for consistent reporting that is externally validated, usually by an audit, and she needs to have confidence in management and their ability to grow.

It can help to have boots on the ground. Calvert’s Streur pointed to the Dakota Access Pipeline as an example of a big social impact issue that has had material financial consequences for the owners.

Private equity managers may have an advantage over managers that only operate in the public markets when it comes to getting information and influencing the efforts of management around ESG issues.

S&P 500 Fossil Fuel Free index,” she said.

Once an investor understands one piece of the puzzle, they often move on to see how the objective could be applied in another asset class.

“Take infrastructure,” Skeates continued. “If you are thinking about a low carbon future that fits with a 2 ° C-aligned world, then you need to think about what qualifies as green infrastructure in that energy transition context and create a definition that is aligned with the broader market.”

Infrastructure investing throws up plenty of ESG issues, some of which are not immediately apparent. Calvert’s Streur pointed to the Dakota Access Pipeline as an example of a big social impact issue that has had material financial consequences for the owners.

PRIVATE EQUITY ADVANTAGE

“The good infrastructure projects engage in dialogue with the local community and indigenous peoples,” he said. “They understand how to get a project done properly. They don’t have work stoppages or lawsuits.” Not understanding the potential impacts of social issues can mean cost overruns and lost revenue.

While sustainability has long been part of the conversation in real estate investing, Schroders’ Ground suggested that “we’re only in the foothills when it comes to talking about ESG factors in alternatives, partly because managers don’t work with a common definition or strong standards yet.” She predicted organizations like PRI will be instrumental in establishing standards that extend throughout the investment landscape.

Private equity managers may have an advantage over managers that only operate in the public markets when it comes to getting information and influencing the efforts of management around ESG issues.

There’s no question that these private equity funds are using are using ESG as part of their due diligence process.

“Many companies that are in private equity hands borrow money, so being able to analyze these securities and loans is very important to the whole ecosystem,” Calvert’s Streur said. •
Companies continue to ramp up the information they provide on issues such as sustainability, governance and social impact, but a lack of standardization has left investors with a mishmash of data. Enter regulators.

"Regulations are helping to focus the minds of the financial services industry so they can pull together the relevant themes and provide the information that asset owners want on ESG," said Hannah Skeates, senior director for strategy and ESG indices at S&P Dow Jones Indices. The Sustainability Accounting Standards Board (SASB) has been canvassing companies to get them voluntarily report data across all ESG issues.

"The key performance indicators that SASB is developing and their materiality map are helping investors and managers," said Bruno Bertocci, head of the Sustainable Investors Team at UBS Asset Management. "These indicators provide industry-specific guidelines for the disclosure of material sustainability factors."

FASB’S TWIN

He describes the SASB as a twin to the Financial Accounting Standards Board (FASB). The two organizations now share some members and while the SASB is a voluntary organization without any regulatory standing, Bertocci pointed out that FASB was as well until it was empowered by the Securities and Exchange Commission.

"There is plenty of good dialogue going on," he said. Companies have been trying for decades to find ways to internally manage ESG activities and report these to investors in a helpful way. There is SEC guidance on disclosing material liabilities, but regulators are silent on the softer points of risk and metrics, including issues such as retention of talent and intellectual property, for instance.

And while companies are disclosing more ESG information, those data still contain a significant amount of boilerplate that is not necessarily valuable in terms of differentiating companies on material ESG factors.

"We would say that across the board, the company-provided information needs continuous improvement," said John Streur, president and chief executive officer of Calvert Research and Management. An example would be the large amount of information that companies have on their diversity practices and their efforts to ensure their employee population has a sense of well-being. Streur said most companies do not provide this information to managers or researchers.

Mary Jane McQuillen, a managing director and portfolio manager at ClearBridge Investments, said that over the past two decades, it has become somewhat easier for investors to find sustainability-related information, particularly from companies that have made the case internally with their boards to support such disclosures.

Yet even then, she continued, "Companies will often wait for more investors to ask for the information before releasing it voluntarily. That situation has prompted our fundamental analysts to continually engage directly with companies over many years and ask for specific relevant ESG information that could be helpful in understanding the company’s longer-term view."

"I see ESG data integration across all aspects of the investment industry," said S&P DJ’s Skeates. "Carbon targets and other ESG outcomes are becoming more normal. Thematic investing is also having a resurgence through indexes that may follow specific themes, such as green bonds or water infrastructure."

SOUND DECISIONS

What is clear is that this investment approach is here to stay and continues to develop. Whether alone or in partnership, managers are working hard to ensure that they can make sound investment decisions that include an assessment of ESG factors.

"It’s important to us to work with our internal partners, like Trucost, and international agencies to encourage greater data disclosure from companies," Skeates said. Last year, S&P Dow Jones acquired Trucost plc, a company that provides carbon and other environmental data.

"If we need more disclosure from companies to promote more investment in certain areas," Skeates said, "it becomes a virtuous cycle of being able to support the idea, create the information flow and see the investment follow."
Why sustainability matters

The 2015 Paris Accord set a 2-degree temperature target to manage climate change risks. Our research suggests that we’re closer to a **4-degree level**, and that nearly **20% of company earnings** are at risk from rising carbon prices.

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**Are your investments positioned to manage these risks?**

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Index builders and managers are incorporating ESG into the newest products

Investors continue to pour money into passive investing, thanks in part to the low fees and the broad coverage that indexes provide. Passive investments were once off the table when it came to implementing an ESG approach, but that’s changed.

In one way this is hardly a surprise, as investors have taken to factor-based investing like ducks to water. Constructing an index that pays heed to environmental, social and governance issues is much the same process.

Index construction, though, is not always straightforward. Investors need to understand the building blocks — which elements of an ESG agenda are included — and how the rules work.

“Calvert builds proprietary ESG indexes by including ESG, impact reporting, proxy voting and corporate engagement considerations — all the elements of responsible investing,” said John Streur, president and chief executive officer of Calvert Research and Management. “We build the index the right way, taking into consideration what we think about being a universal owner for the long term.”

As an index provider, S&P Dow Jones Indices pursues multiple aims in the ESG arena. “We can provide customized indices that are useful to asset managers in creating products for different client types,” said Hannah Skeates, senior director for strategy and ESG indices at S&P Dow Jones Indices. “We obviously create benchmarks, and there’s a deepening debate about which benchmarks are appropriate to use, depending on the kind of asset owner or investor you are.”

CHALLENGES

Since the focus in ESG investing is on integrating the issues into a larger investment process, it can sometimes be hard to properly attribute the effect of using these metrics on performance.

This is just one of the challenges that passive investing poses for investors who are looking to reflect
sustainable aims in their portfolio but don’t necessarily want to use active management.

Bruno Bertocci, head of the Sustainable Investors Team at UBS Asset Management, reported that his firm is working on a climate-aware strategy for investors that hold index portfolios. The strategy starts by looking at the carbon intensity of all the companies in a benchmark and then comparing each to the carbon budget for its industry.

“What we are really interested in is the future and the path each company is taking toward the 2-degree world,” he said. “The index would then tilt toward those that are not as carbon-intensive, both today and in their future commitment.” The 2-degree world refers to the Paris climate accord’s aim of holding the global average rise in temperatures to just 2 degrees Celsius relative to pre-industrial levels.

**ABSOlute Duty**

“If you use an index at all, then you begin to take on the characteristics of a universal, permanent owner in these companies,” Calvert’s Streur said. “I think you have an absolute duty to send feedback to those companies through the proxy voting system, potentially filing your own shareholder resolutions, which we do, as well as through direct corporate engagement. To have passive money of any type not fully engaged is a problem.”

As the ESG agenda rises in importance and more research becomes available, expect to see new ways of seizing the opportunities that this investing prism throws up.

“We see the trend toward thematic investing as linking quite nicely with the UN Sustainable Development Goals because these are centered around themes as well,” S&P DJI’s Skeates said. “The issue is how to make these ideas accessible and investible from an index and investor point of view in a meaningful way.”

**The Performance Conundrum: Much Ado About Nothing?**

Fiduciary duty also entering the return discussion

Despite mounting evidence to the contrary, investors still ask if they need to give up return to pursue an ESG agenda.

“My experience as a manager, as well as academic evidence, shows that companies that manage ESG risk in a proactive way benefit from a lower cost of capital,” said Jessica Ground, global head of stewardship at Schroder Investment Management. “These companies face fewer controversies and are anticipating the way the world is changing, especially in areas of transparency.”

And lower cost of capital, of course, can help drive solid financial results, which typically lead to better stock performance.

Indeed, Ground pointed to Schroders' emerging market equity process, which has integrated ESG factors for many years while producing strong risk-adjusted returns.

According to Mary Jane McQuillen, a managing director and portfolio manager at ClearBridge Investments, the question of risk vs. return comes down to a manager’s skill and experience.

She cited research from academics, consultants and the CFA Institute that found that an ESG investment approach can more often provide competitive risk-adjusted returns when compared to more traditional active investing methods, and may be slightly better in some cases.

In addition to considering issues of performance, asset owners are also concerned about meeting their fiduciary duty.

“We know that a number of legal studies over the last 10 years have established that ESG investing would not be a violation of fiduciary duty,” McQuillen said. “Yet we still find plan sponsors and others asking, ‘Will I violate my fiduciary duty by looking at ESG investing?’” Rather, the global legal reviews found that in most country jurisdictions, it would be a violation of fiduciary duty to not consider long-term environmental, social and governance issues into the investment analysis.

The best way to answer that question is through education.

“The more informed and better-equipped you are,” she said, “the more meaningfully you could recommend or allocate to ESG investments.”
Climate change and carbon footprint are on investors’ front burners

If there is one issue that defines investor focus on ESG factors, it’s climate change. And the prospect of a 2-degree Celsius world, in which companies and countries all work together to put a ceiling on rising global temperatures, is the central theme galvanizing investment activity.

Mary Jane McQuillen, a managing director and portfolio manager at ClearBridge Investments, said corporate America is far ahead of both the U.S. federal and state governments in terms of a commitment to clean energy and renewable power. “We don’t think our approach to ESG investing will be significantly impacted by the current federal administration’s thinking on climate change,” she said. “Asset owners have the greatest opportunity to grow their commitment to clean power and energy efficiency by investing in U.S. companies.”

That’s important for managers and asset owners. “We hear that plan sponsors are getting trickier questions from their beneficiaries on issues like climate change,” said Jessica Ground, global head of stewardship at Schroder Investment Management. “They realize that they have to be forward-looking here by integrating ESG in a way that helps good returns and assuages the concerns of those beneficiaries.”

COLLABORATION

Although conversations around ESG have been going on for some time, investors still have to get involved in the details of the topic to implement it in a holistic way in portfolio management. “We see lots of collaboration and efforts to highlight good practice in presenting information in an easily digestible format,” said Hannah Skeates, senior director for strategy and ESG indices at S&P Dow Jones Indices. For example, she pointed to S&P DJI’s Carbon Scorecard, which assesses the carbon risks and opportunities of major global equity indexes, in five different ways, demonstrating the enhanced insight provided by a range of metrics.

“The data around carbon is still pretty poor,” Schroders’ Ground said. “About 40% of carbon footprints in U.S. companies are estimated, so having more managers ask for more information is very useful.” Large players in the passive investing area are joining these efforts. “If you are building a carbon-strategy index, you need to think about the detail,” Skeates said. “What are the carbon exposures of all the different companies on a standard basis? Robust data, along with the ability to complete data gaps with a robust approach, is key since many companies still do not report environmental performance information.”

GREEN BONDS

In fixed income, interest in climate change is ramping up quickly. The market for green bonds is growing, pushed along by the World Bank, among others. Importantly, sustainability factors are being integrated into corporate bond analysis. “It gets a bit more complex when you are talking about the sovereign bond market and other areas,” said Bruno Bertocci, head of the Sustainable Investors Team at UBS Asset Management. “Bonds are a bit behind equities, as that’s the area that has developed the most to date.” Yet again, questions of definition arise. “Many bonds that are issued to finance important environmental issues and projects are not labelled as green,” said John Streur, president and chief executive officer of Calvert Research and Management. “For us, we may be able to use that kind of bond in our green bond fund if it met certain criteria.”

Being clear about criteria is important. Just because a bond is labelled green doesn’t mean it is green. “On the face of it, green bonds look like a great thing,” Schroders’ Ground said. “Unfortunately if you lift up the lid, you can find that the railway funded by the green bond is transporting coal from a coal mine. It is important for investors to really understand what the bonds are funding, as not all green bonds are the same.”
S&P Dow Jones Indices

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