Swisscanto Invest
by Zürcher Kantonalbank

Responsible – Investing in a responsible manner

Systematically reducing ESG risks

100% Swiss Made Asset Management

Legal notices

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swisscanto.ch/sustainability

Systematically reducing ESG risks

For us, responsible investing or reducing ESG risks (environment, social and corporate governance) means excluding investments that are contentious in terms of their sustainability, while having the risk/return profile remain comparable with that of traditional investments.

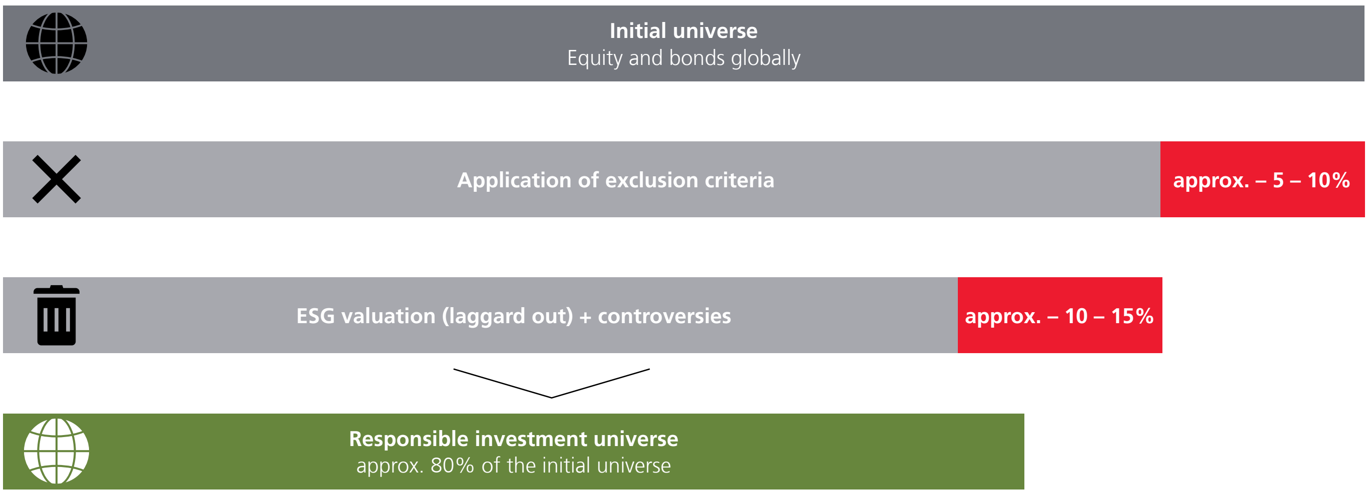
Responsible – Two-stage filter process
For the Responsible investment universe, companies undergo a two-stage filter process. Around 20% of companies are excluded under this process. Dispensing with this part of the investment universe does not notably change the risk/return profile.

In the first step, those companies are excluded which are active in controversial areas, such as in the manufacture of weapons, alcohol or tobacco.

In the second step, those companies with the lowest ESG valuations per sector and region (laggard out) and which are highly controversial are identified.

The Responsible approach is applied at present to the companies in the MSCI All Country World share index (the regions of Europe, North America, Pacific and emerging markets, comprising around 2,500 companies), as well as the Barclays Global Aggregate Corporates bond index (global, comprising around 2,400 issuers) – but not to government bonds and supranational organisations.

Responsible process



Exclusion criteria

The application of exclusion criteria is the first step in the two-stage filter process. Companies are excluded, if they engage in business activities in certain controversial areas.

With the Responsible approach, a set of eight exclusion criteria is specifically applied, which is mainly based on social and ecological value concepts. These include weapons manufacturers or companies using child labour in their operations. By applying these exclusion criteria, approximately 5 – 10% of the companies in the investment universe are removed.

Examples of excluded companies

Leonardo SpA

The Italian company Leonardo SpA is one of the largest arms manufacturers worldwide. In addition to the manufacture of military aircraft and inter-continental missiles, the company also develops autonomous military robots. The company also supplies states, which disregard human rights or are engaged in armed conflicts, including unstable countries in the Middle East and North Africa.

Wilmar International

Wilmar International is one of the largest processors and distributors of palm oil and other oils. The company operates palm oil plantations in Indonesia and Malaysia. It has been repeatedly associated with the slash-and-burn clearance of primary forests, the destruction of rich biodiversity and the enormous release of carbon dioxide and other air pollutants. In addition, breaches of workers' rights have been documented and Amnesty International has identified the use of child labour by subsidiaries and suppliers.

Exclusion criteria for the Responsible approach, share of the MSCI World equity index and company examples

Global risks	**Exclusion criteria**	**MSCI World alloc.** (market capitalisation)	**Company examples**
Anthropogenic climate change	▪ Companies with their own coal reserves	▪ 2.0%	▪ BHP Billiton, South32
Decline in species diversity	▪ Genetic engineering (release of GMOs)	▪ 1.3%	▪ Bayer AG, DowDuPont Inc.
Risk to society and health	▪ Manufacture of weapons and military equipment ▪ Manufacture of tobacco and smokers' accessories ▪ Manufacture of alcohol* ▪ Child labour (in company's own operation) ▪ Gambling* ▪ Pornography (producer)	▪ 2.0% ▪ 1.0% ▪ 1.1% ▪ 0.1% ▪ 0.4% ▪ 0.1%	▪ Lockheed Martin, Leonardo SpA ▪ Philip Morris, Japan Tobacco ▪ Diageo Plc, Kirin Holdings ▪ Wilmar International ▪ Wynn Macau, Galaxy Entert. ▪ MGM Resorts, Take-Two Inter.

*5% turnover threshold, i.e. the share of turnover for the controversial activity must be at least 5% of total turnover to justify an exclusion.

Source: Swisscanto Invest, MSCI

Identification of companies with a low ESG valuation (laggard out)

In the second step of the filter process, companies are identified, which do not control their ESG risks sufficiently. The worst companies (per region and industry) are excluded as a result. To do so, Swisscanto Invest evaluates the companies using a proprietary model based on more than 45 indicators from the following areas:

1. Environment (E)
2. Social (S)
3. Corporate Governance (G)

The raw data is obtained from external providers: MSCI ESG, RepRisk, Asset4 and Trucost.

In addition, highly controversial companies are excluded in this step. From the approximately 2,500 companies in the MSCI All Country World index at present, around 35 companies are affected by major controversies, mainly due to environmental offences, followed by serious breaches of human rights and serious violations of good business management. These companies are excluded from the Responsible universe.

Examples of controversial companies

Petrobras
The semi-sovereign company Petrobras is one of the largest oil companies and supplies crude oil and natural gas (offshore and onshore). In 2014, the largest corruption and money-laundering scandal in Brazil was discovered, which achieved notoriety under the name "Operation Car Wash".

Freeport-McMoran
Freeport-McMoran is one of the largest mining concerns in the world and is mainly involved in the supply of copper, gold and molybdenum. In West Papua, Indonesia, the company has a majority interest in the contested Grasberg mine. This mine supplies gold and copper and is involved in major breaches of human and labour rights. This involves insufficient safety measures and the mistreatment of the indigenous Papuan population. By feeding contaminated mine run-off into the surrounding water sources, the ecological system has been destroyed on a large scale and the local population is denied access to clean water.

Overview of ESG criteria and weighting of the individual topics
Environment, social and governance aspects each contribute one third to the ESG valuation.

E – Environment	
▪ Environmental impacts	50%
▪ Environmental management	25%
▪ Transparency	25%

S – Social	
▪ Reputation risk	40%
▪ Working conditions	15%
▪ Diversity	15%
▪ Health	15%
▪ Stakeholder	15%

G – Governance	
▪ Corporate governance	80%
▪ Reporting	20%

Environment (E)
A sustainable handling of resources and an effective climate strategy have become important competitive factors, for example due to rising commodities prices and a changing regulatory environment. Companies which are among the worst in their industry ecologically, harbourgreater environmental risks and are threatened by competitive disadvantages.

The environmental component of the ESG analysis encompasses a range of indicators with a focus on the topics of environmental management systems, climate change and environmental aspects in supplier requirements:

- Companies with a good environmental management system can, for example, lower costs through energy savings or consume fewer resources in product manufacturing.
- Environmental risks in the supply chain can be reduced by way of environmental requirements for suppliers.
- Changes to legislation can mean that companies have to pay more for the "external costs" which their environmental impacts cause.

To date, external costs have scarcely appeared in companies' financial accounts. A quantification of the environmental impact of a company is becoming more and more important for investors due to the increasing internalisation of these costs. The British firm Trucost has developed an innovative valuation model to estimate external costs. It sets the total of all external costs in relation to the company turnover and thereby allows a direct comparison of individual companies and industries.

Credit agencies, such as Moody's or S&P, consider environmental risks to be increasingly relevant. Environmental risks can strongly influence ratings in the credit analysis. Thus, for example, climate change is an important factor for utilities and energy firms.
A global divestment movement is already happening for coal: major institutional investors, such as Allianz, the Swiss Federal Pension Fund or Swiss Re, have decided to reduce their investments in coal or do away with them entirely. The increasing CO_2 content in the atmosphere is the main factor of climate change in the view of scientists.

To prevent serious effects from climate change, the international community declared at the UN Climate Conference in 2015, that the global rise in temperatures should not exceed a value of 2°C above the pre-industrial level. To achieve this climate goal, CO_2 emissions (coal, crude oil and natural gas) must be reduced by more than 50% from 1990 levels by 2050 and fossil fuel reserves should remain unused. Companies affected would have to accept value losses, referred to as "stranded assets". As high depreciations for "stranded assets". could have relatively drastic effects on the financial markets, a carbon bubble is discussed in this context.

With the Responsible approach, investment in companies with coal reserves is already excluded by the application of the exclusion criteria. In combination with the exclusions due to lower ESG valuations, the carbon footprint of the Responsible universe is reduced relative to the benchmark by 15 to 20%.

Social (S)

The treatment of employees and stakeholders as well as the avoidance of reputational losses have an influence on the long-term existence and economic success of a company. Companies with low social standards risk losing their appeal as an employer in addition to customer confidence. For that reason, topics such as working conditions, staff diversity, human rights and dealings with interest groups are assessed under the heading "Social". The reputation risk is measured by the RepRisk index, a measure of risk which quantifies the criticism of a company and its exposure on contentious sustainability topics in the media. It evaluates the source's relevance as well as the frequency and content of the reports (severity and topicality).

Corporate Governance (G)

Good business management is the basis for stable development. A high quality of management reduces operational risks, whereby the scope for self-interested management behaviour is limited. In addition, the risk of legal disputes or damage to corporate image is reduced by way of improved inclusion of other stakeholders (authorities, employees etc.). Corporate governance relates both to management structures in companies as well as the behaviour of decision makers. The criteria for the evaluation of business management can be divided into six areas:

- Responsibility of governing bodies: indicators are transparent guidelines, independence of the board of directors or dealings with related parties.
- Accounting practice, transparency and control: here the accounting practice and risk management committees are examined for their independence and expertise and it is clarified whether irregularities in the accounting practices have been recorded in the past.
- Shareholders' rights: equal voting rights for all shareholders or the possibility for minorities to assert their interests are an advantage here, for example.
- Remuneration: long-term salary incentives, quantitative performance goals or agreements on the salary policy by the annual general meeting are given a positive weighting.
- Concentration of power: a highly concentrated shareholder structure or articles of association, which prevent a targeted change in leadership, hold the risk of a unilateral representation of interests.
- Corporate behaviour: lastly, compliance with guidelines and legislation is measured on the basis of media reports and legal documents.

Empirical literature supports the argument that taking governance factors into account favours a more consistent and above-average performance. For some indicators, a significant effect on cost of capital and company valuation can be demonstrated. Independent audit reports or the lack of investigations by authorities contribute, for example, to a higher share price to book value ratio. Better accounting lowers the cost of capital.

Investing sustainably with Swisscanto Invest – Overview

Swisscanto Invest offers two lines of investment in the ESG area for a range of customer needs: **Responsible** for the systematic reduction of ESG risks and **Sustainable** to achieve returns with societal benefits.

Responsible – Systematic reduction of ESG risks
With the Responsible approach, the most controversial companies from a perspective of sustainability are systematically excluded – while maintaining a return profile that is comparable with that of traditional investments. As a result, those companies are excluded, which exhibit insufficient management of ESG risks, have committed gross violations of or breaches against international standards or whose activities are rated critically based on ecological or social considerations.

Sustainable – Systematic focus on returns with societal value
The products under the stricter sustainability approach of the Sustainable portfolio extend beyond the risk perspective and use investment opportunities to achieve a societal benefit. Swisscanto Invest is convinced that companies that provide a social benefit are more successful, as they have products and services that will generate above-average demand in the medium term.

ESG approaches of Swisscanto Invest compared

	Responsible	Sustainable
Objective	Systematic reduction of ESG risks	Systematic focus on returns with societal value
1st Step Application of exclusion criteria	Limited exclusion criteria exclude around 5 – 10% of companies.	Broad exclusion criteria exclude around 20% of companies.
2nd Step Application of ESG filters	"Laggard out" Through analysis of 45 ESG criteria, the **least** sustainable companies are **excluded**.	"Best in class" Through analysis of 45 ESG criteria, the **most** sustainable companies are **identified**.
3rd Step Sustainability impact analysis	–	By means of an impact analysis, the companies with the highest societal benefits and strong growth prospects are identified.
Result	Responsible investment universe: initial universe reduced by 20%.	Sustainable investment universe: initial universe reduced by 70%.
Implementation	The selection of shares and bonds from the Responsible investment universe for our Responsible funds, which have a risk/return profile that is comparable with that of traditional funds.	The selection of shares and bonds from the Sustainable investment universe for our sustainability-focused Sustainable funds, which have a risk/return profile that deviates from that of a traditional investment.

A pioneer in sustainable investments

Swisscanto Invest is a pioneer in the area of sustainable investments and launched the first investment solutions back in 1998. In 2009, Zürcher Kantonalbank, the proprietor of the Swisscanto Invest brand, became one of the first full-service banks in Europe to sign the six Principles for Responsible Investment (PRI) of the United Nations. It thereby reiterated its conviction that the integration of ESG themes in investment decisions and active shareholder relations is a prerequisite for fiduciary responsibility in wealth management. The UN PRI (Principles for Responsible Investing) international investor initiative regularly coordinates social or ecological engagements for more than 1,700 signatories with a volume of investment of around USD 75 billion. Swisscanto Invest regularly takes part in these joint engagements under the UN PRI platform. Regular dialogue is also carried out with the management of companies on ESG topics.

Exercising of voting rights
Swisscanto Invest uses its voting rights actively: the voting guidelines of Swisscanto Invest are based on Swiss and international corporate governance standards, as well as the principles of the UN PRI, which incorporate a comprehensive set of environmental, social and corporate governance principles into the decisionmaking process. In the analysis and decision-making process for the voting procedures at general meetings, Swisscanto uses the assessments of the independent voting right adviser ISS (Institutional Shareholder Services) and our investment specialists in Asset Management. The voting procedures are set out in detail at swisscanto.com.

Sustainability Advisory Committee
Swisscanto Invest rounds off its know-how with an independent sustainability committee through an external specialist department. Several renowned specialists – including from the Climate and Environmental Physics Department of the University of Berne – monitor thecurrent investment universe and the conceptual development of the sustainability approach.

Detailed information about the various sustainable investment solutions by Swisscanto Invest can be found on our website: swisscanto.ch/sustainability.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