MAERKI BAUMANN & CO. AG
PRIVATBANK

Sustainability-related investments

A look into the world of green investing

What is sustainable investing?
While there are various definitions of sustainable investing, it is generally referred to as the process of considering environmental, social and governance factors (ESG) when making investment decisions, leading to an upturn in the volume of investments with a longer-term focus being made in sustainable economic activities and projects.[1] Sustainable investing exists within a broad spectrum of investing that is based on financial and ESG criteria. On one side, traditional investments are made with the goal of maximising shareholder or debtholder value through financial returns based on absolute or risk-adjusted measures of financial value, with no consideration being given to any positive impact on ESG criteria. On the opposite side, there is philanthropy, which is fully geared towards generating a positive social and/or environmental impact. Sustainable investing exists in the middle of this spectrum, striving to minimise ESG risks and/or bring about positive change while also maximising financial returns.[2] The range of investment approaches can be categorised as follows:
- Traditional investing
- Socially responsible investment (SRI)
- Sustainable investing
- Impact investing
- Philanthropy

Given the complexity of the market, it is hardly surprising that both clients and investors often find themselves confused. The following article on this financial topic sheds light on the different shades of green in the investment world.

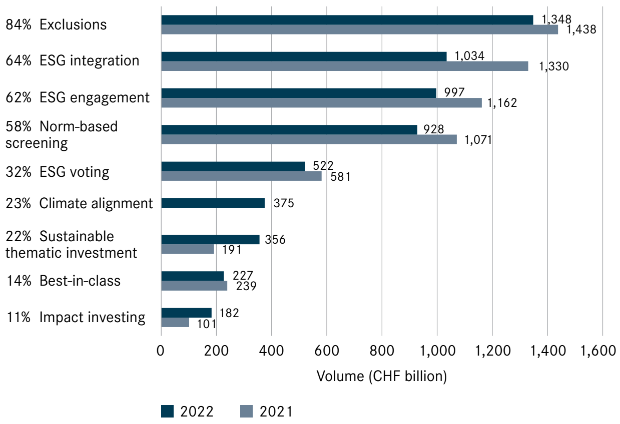
The market for sustainable investing
Looking at the Swiss market, in particular, it can be seen that after two years of strong growth in terms of sustainability-related investing volumes (volume growth in 2021 of 60% to CHF 1,982.7 billion),[3] 2022 was the first year in which a decrease was recorded, with volumes falling by 19% (mainly due to negative market performance).[4] If we turn our attention to sustainability-related funds, it becomes apparent that in 2022 they accounted for more than half of the entire Swiss fund market (52%).[5] This finding provides further evidence of the growing popularity of sustainable investing in Switzerland.[6]

Most sustainable investing is based on negative/exclusionary screening, as this approach is the easiest to implement. This tends to be the starting point for investors wanting to integrate ESG factors into their investment process and/or their portfolios. Negative screening generally involves the exclusion of tobacco, arms manufacturers and nuclear weapons, for example. The aim of these portfolios is not primarily to generate a positive impact, but rather to avoid investments being made in harmful industries and to align the portfolio with the investor's values. In the Swiss market, exclusion remains the most prominent investment approach, and is applied for 84% of all sustainability-related investments.[7] One of the key exclusion criteria in the Swiss market is coal, with the application of this criterion having almost doubled since 2020.

Negative screening and exclusion approaches provide a good basis for addressing the issue of sustainability within the investment space. However, many market participants anticipate that in the not too distant future this will no longer suffice for investments to be labelled sustainable.[8] Instead, ESG criteria are likely to become an integral component of any investment advisory and/or asset management mandate. In this context, it is encouraging to note that sustainable thematic investments recorded the highest growth of any investment approach in Switzerland in 2022, posting an increase of 86% (following on from the increase of 157% in the prior year.)[7]

[1] Boffo, R./Patalano, R. (2020): "ESG Investing: Practices, Progress and Challenges", OECD, p. 6
[2] CFA (2021): "Certificate in ESG Investing", chap. 1, p. 6–11
[3] SSF (2022): "Swiss Sustainable Investment Market Study 2022", p. 17
[4] SSF (2023): "Swiss Sustainable Investment Market Study 2023", p. 8
[5] SSF (2023): "Swiss Sustainable Investment Market Study 2023", p. 34
[6] SSF (2023): "Swiss Sustainable Investment Market Study 2023", p. 4
[7] SSF (2023): "Swiss Sustainable Investment Market Study 2023", p. 9
[8] Uzsoki, D. (2020): "Sustainable Investing: Shaping the future of finance", International Institute for Sustainable Development, p. 4

Development of volumes of different sustainability approaches



Source: Swiss Sustainable Finance: "Swiss Sustainable Investment Market Study 2023"

Growth drivers of sustainable investing

Private investors

Private investors – specifically millennials and following generations – will in future play a significant role in the increasing demand for sustainable financial products and services.[9] This can be explained by the shift in social and environmental awareness as well as a different system of values. With the climate crisis worsening, it has become clear that systemic change is needed in order to prevent permanent damage to the environment. A survey conducted by Morgan Stanley found that millennials are twice as likely to invest in companies if they pursue social or environmental goals.[10] With the huge intergenerational wealth transfer that is currently taking place, we may see a dramatic spike in demand for sustainable investing. Increasingly, private clients are thus actively searching for sustainable solutions and now expect that their providers offer up information with respect to sustainability performance and the impact of their products and services. Over recent years, the issue of sustainability has also become increasingly important amongst older generations of private investors.

Institutional investors

Pension funds, central banks and asset managers, i.e. institutional investors, will collectively play a vital role in driving the growth of sustainable investing. While private investors are more focused on aligning their portfolios with societal values, institutional investors want to derive the benefits offered by ESG investing in fulfilling their fiduciary duties.[11] As they have substantial financial resources at their disposal, they have the capacity to influence capital flows, moving them in the direction of environmentally and socially responsible companies and projects.

Central banks and legislators will also have a significant role to play in the development of sustainable investing.[12] They can influence the market through various mechanisms, including monetary policy, regulations and guidelines. For example, central banks and legislators can provide incentives for financial institutions to invest in sustainable assets by implementing favourable regulatory frameworks, setting capital requirements or offering liquidity support for green projects.

Asset managers bridge the gap between institutional investors and private investors: they leverage their expertise to provide sustainable investment strategies and products, catering to the growing demand for investments that align with environmental and social values. Asset managers therefore take on great responsibility in identifying and supporting companies that are trying to make a positive impact on the environment and society.

Regulatory initiatives

In addition to market-based mechanisms, the increase in regulations has emerged as a significant catalyst for the growth of sustainable investing. Governments and regulatory bodies worldwide, for example, have recognised the need to address urgent environmental and social challenges. They are implementing policies and regulations aimed at fostering sustainable practices and holding companies accountable for their impact – be it positive or negative – on the planet and society.

One notable regulatory development in Europe is the Sustainable Finance Disclosure Regulation (SFDR). The SFDR requires asset managers to classify financial products as either "Article 6", "Article 8" or "Article 9" funds. "Article 6" covers products that do not take ESG criteria into account. "Article 8 funds", or "light green" funds, promote environmental or social characteristics, whereas "Article 9 funds", or "dark green" funds, have a specific sustainable investment objective. One such example here are funds that are geared towards achieving an environmental or social impact. Dark green products are often aligned with a thematic focus such as the circular economy or gender equality.

Performance

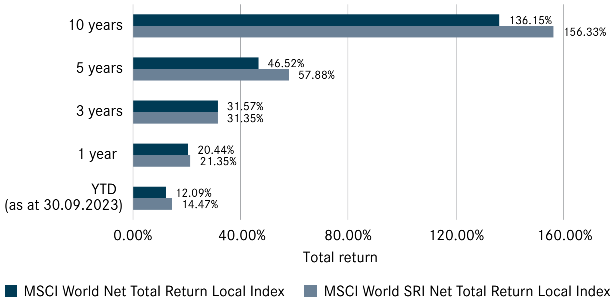
There is a general misconception that investing sustainably involves a trade-off in terms of financial returns. This is not necessarily the case. In the past few decades, numerous research studies that have examined the relationship between ESG factors and risk/return have generated inconclusive findings. Nevertheless, the majority of studies have indeed identified a positive correlation, meaning that the integration of ESG factors can be beneficial for investors as well, especially over the long term.

[9] Boffo, R./Patalano, R. (2020): "ESG Investing: Practices, Progress and Challenges", OECD, p. 17
[10] Morgan Stanley (2017): "Millennials Drive Growth in Sustainable Investing", Institute for Sustainable Investing
[11] Uzsoki, D. (2020): "Sustainable Investing: Shaping the future of finance", p. 10
[12] Uzsoki, D. (2020): "Sustainable Investing: Shaping the future of finance", p. 11

A research study conducted by MSCI (a renowned provider of equity indices) examined 1,600 stocks within the "MSCI World Index" and analysed them over a period of 10 years. As part of their analysis, they divided companies into five ESG categories based on their ESG scores. In doing so, they found that firms with higher ratings were more profitable and paid higher dividends than those in the lower categories. Firms with higher ratings also exhibited a less marked degree of market correlation and thus lower costs of capital, lower earnings volatility and lower systematic volatility. In summary, it was noted that improved ESG characteristics gave rise to increasing valuations over time.[13]

The chart below compares the returns of the "MSCI World Index" and its socially responsible counterpart, the "MSCI World SRI Index".

Comparison of returns



Source: Bloomberg as at 30.09.2023

As the chart shows, the "MSCI World SRI Index" outperforms the "MSCI World Index" over both the short and long term. Even if this finding remains the subject of fierce debate, the conclusion can still be drawn that sustainable investing does not necessarily have to go hand in hand with lower returns. What is more, taking account of ESG criteria, including with a view to ensuring comprehensive risk management, has become established best practice in the asset management industry.

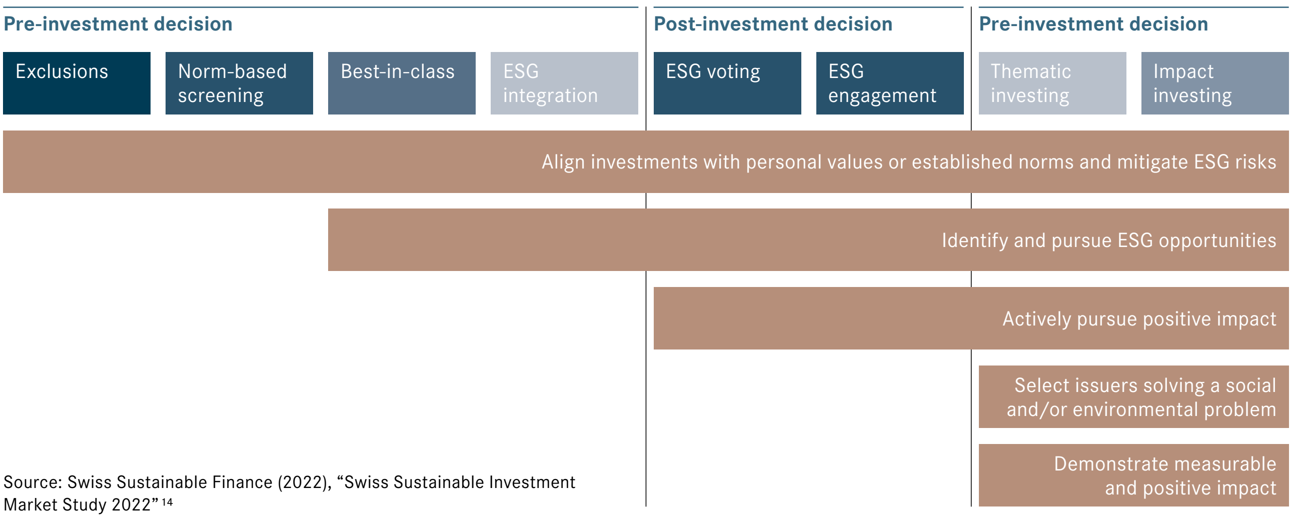
Different shades of green

Sustainable investing builds on various approaches and has many different facets or shades of green – namely the eight different investment approaches presented at the bottom of this page that are often used in combination. These not only aim to meet different investor preferences with respect to sustainability, but also start at different points in the investment process, as the chart below shows.

Sustainable investing at Maerki Baumann

Since the beginning of 2023, Maerki Baumann has supplemented its tried-and-tested investment process with ESG criteria and reduced its investable investment universe accordingly. Two basic tools include negative and norm-based screening of certain issuers and/or financial instruments (products, sectors, countries and business practices) based on Maerki Baumann's ethical and moral values, risk assessment and market standards. Certain sectors, issuers or securities are excluded, in particular, in order to avoid companies with harmful business concepts (e.g. companies that have any ties to cluster munitions, landmines, biological/chemical weapons, depleted uranium weapons, blinding laser weapons, incendiary weapons, and/or non-detectable fragments) and to minimise ESG or extreme risks (so-called "tail risks"). Furthermore, the application of norm-based screening ensures the exclusion of issuers whose business practices violate internationally accepted norms or minimum standards (e.g. UN Global Compact and International Labour Organization) and aims to align the portfolio with values and ethical considerations.

Different sustainability approaches and their goals



Source: Swiss Sustainable Finance (2022), "Swiss Sustainable Investment Market Study 2022"[14]

[13] Giese, G./Lee, L./Melas, D./Nagy, Z./Nishikawa, L. (2019): "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance", The Journal of Portfolio Management, Vol. 45, No. 5

[14] Definitions regarding the different investment approaches can be found on page 14 of the "Swiss Sustainable Investment Market Study 2023" (Swiss Sustainable Finance).

As part of our asset management services and innovative modular investment solution, we strictly refrain from using financial instruments that violate our exclusion criteria. This excludes a few alternative asset classes where ESG standards are just emerging.[15] Finally, we do not recommend any financial instruments to our investment advisory clients that are not in line with the ESG guidelines of Maerki Baumann.

We further reduce our investment universe by avoiding the use of so-called "laggards". These are issuers that perform worst in each industry or sector from a sustainability perspective. Based on the remaining investment universe, we apply ESG integration, in other words the systematic and explicit inclusion of material environmental, social and governance factors in our investment analysis and decisions.[16] This provides further information and insights and not only allows for well-founded investment decisions to be taken, but also ensures better risk management. The key objective of ESG integration is therefore the achievement of a better risk/return profile for the portfolio in question.[17] The modules of Maerki Baumann must thus meet certain volume-weighted minimum requirements in terms of ESG rating[18] and implied temperature rise.[19] These criteria are reviewed annually and further tightened if necessary.

Outlook for the future

In light of the growing demand for sustainable investing, the number of ESG-related indices and funds has multiplied. This development has been accompanied by a wide array of metrics, methodologies and approaches that have led to varying outcomes, leaving ESG investment practices and performance indices widely open to interpretation.[20] In order to overcome this challenge, the industry will need to embark on a journey of harmonisation by improving transparency, international consistency and comparability in (fund management) strategies so as to actually unlock the potential benefits offered by ESG investing.

The setting of standards in the area of sustainability is greatly influenced by the regulatory initiatives of the European Union (EU), which are also likely to have a considerable impact on developments in the Swiss financial centre over the medium term. Domestically, the Swiss Government and the Swiss Financial Market Supervisory Authority (FINMA) are also actively working towards overcoming the challenge of harmonisation and promoting transparency. More specifically, the government has made an appeal to the finance industry to provide transparency on climate alignment, while FINMA has emphasised the need for greater standardisation and the importance of providing comprehensive information on fund processes.[21] Nevertheless, the regulatory landscape in Switzerland regarding sustainability remains highly fragmented.[22]

In this context, it is also worth mentioning the efforts of various industry organisations, including the Association of Swiss Asset and Wealth Management Banks (VAV), which has defined priorities for action in the area of sustainability and regularly reviews them. Such market-based initiatives within the industry as well as independent action taken by individual banks will remain key to achieving the overarching sustainability goals. It is therefore essential that a healthy balance between regulatory intervention in the market mechanism and the preservation of entrepreneurial freedom is maintained at all times.

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[15] Exception: the Private Equity, Venture Capital, Commodities, Bonds High Yield and Cryptocurrencies focus modules
[16] Definition of UN PRI
[17] Giese G., Lee L., Melas D., Nagy Z., and Nishikawa L. (2019): "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance", The Journal of Portfolio Management, Vol. 45, No. 5
[18] The ESG rating assesses the resilience of companies to industry-specific, long-term and financially relevant environmental, social and governance (ESG) risks and shows how the company manages the relevant risks.
[19] The implied temperature rise (e.g. for company A) measures how strongly the earth temperature will increase by 2100 if all companies behave like company A currently does, and additionally measures to what extent company A complies with the global temperature goals (e.g. Paris Agreement).
[20] Boffo, R./Patalano, R. (2020): "ESG Investing: Practices, Progress and Challenges", OECD, p. 3
[21] SSF (2022): "Swiss Sustainable Investment Market Study 2022", p. 4
[22] SSF (2023): "Swiss Sustainable Investment Market Study 2023", p. 10

Editorial deadline: October 2023

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