Identifying Sustainable Rising Stars in Total Return Investing

Dear Reader,

Over the last few years, as research in sustainability has deepened and we now have more granular ESG data, integrating sustainability with fixed income investing has become even more viable.

This has given us confidence to integrate sustainability with our Total Return strategy – a flexible, global, and non-benchmarked approach to fixed income investing. To do so, we adopt a "worst-out" approach, which allows us to mitigate risks by avoiding issuers with the poorest ESG ratings, but gives us the flexibility to invest in "rising stars". For us, these are issuers who may not be "best-in-class" in ESG terms today, but show promising signs of making significant improvements in the near future. This helps us to identify attractive investment opportunities with the biggest upside potential.

Ultimately, we are convinced that sustainability elevates our Total Return strategy to the next level. In this Spotlight, we elaborate on our approach to integrating ESG with a Total Return Fixed Income strategy.

Kind Regards,


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Traditionally, the topic of sustainability has been more of a focus for equities. However, fixed income has caught up over the last few years, supported by better information, deeper insights, more sophisticated tools, and above all, increased awareness and demand from investors.

Recently, J. Safra Sarasin Sustainable Asset Management's Fixed Income Total Return strategies have also made additional steps to incorporate sustainability into its investment approach. In this Spotlight, we highlight why integrating environmental, social and governance (ESG) factors with Total Return investing brings added value. We also discuss how we have incorporated ESG with a Total Return approach.

Integrating ESG and Total Return adds value

It has always been a part of fixed income manager's DNA to focus on downside risks. For instance, the manager assesses interest rate, credit or any type of risks that may alter the ability of the issuer to repay its debt, and more generally any risk factor that may negatively impact a bond's price. In that respect, ESG factors have always been at the back of the minds for a credit analyst or a bond fund manager.

What has changed over the last few years is the wealth of information about ESG data that has become available, as well as the granularity of this data. Environmental issues, for instance, are more important for heavily polluting sectors (i.e. those with high CO_2 footprint or high water consumption) while social and governance topics tend to be determining drivers across all sectors. Having more ESG data and deeper granularity allows investors to better assess the impact of various factors for different issuers across a broad range of sectors. Additionally, although the majority of ESG research papers initially focused on equities, more research has been produced recently in the fixed income space to address the specificities of solvency issues or credit risks associated with ESG factors.

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In our experience, we have found that applying the lens of sustainability to our investment process has been key in identifying and mitigating credit risks, while helping to capture attractive opportunities.

The road to ESG investing in Total Return

Our Total Return strategy is flexible, global, and non-benchmarked. We follow a well-defined and structured investment process based on identifying strategic investment themes. The portfolio construction involves combining investment themes with different drivers and low correlations between them, in order to generate an attractive risk-adjusted return. A successful outcome happens when the ex-ante diversification significantly reduces the portfolio's overall risk versus the sum-of-the parts, as measured in Value-at-Risk.

Since the launch of our Total Return strategy in 2015, hard exclusions of controversial activities have been applied, as this has always been deeply anchored in our ethical and responsible values. This is also aligned with our overall philosophy of focusing on quality issuers, which often coincides with issuers that act responsibly, and have solid governance structures.

More recently, we have started taking further steps to integrate ESG into our investment process, by opting for a **"worst-out" approach**. We favour this approach as it gives us the flexibility to identify and invest in attractive "rising stars" that demonstrate signs of improving ESG profiles and ultimately, returns.

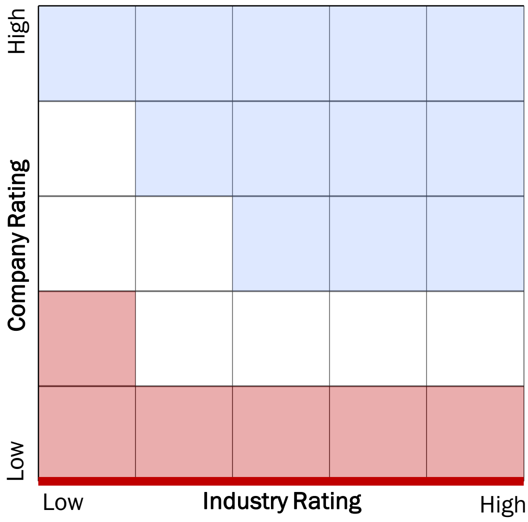
In simple terms, the "worst-out" approach involves identifying and discarding issuers that are at the bottom of every sector. Issuers falling into this "worst-out" category, also known as C-rated, are generally not investible as they are likely to have the highest ESG or reputational risks. As shown in Exhibit 1, this is marked by the red shaded area. Conversely, our Total Return strategy is free to invest in issuers that are A-rated ("best-in-class") or B-rated. This gives the opportunity to invest in companies that are not yet "best-in-class", but are moving in the "right direction". This principle is also reflected in our credit selection, where we prefer holding a double-B-rated issuer that is on an improving trajectory, and a possible candidate for an upgrade to triple-B. The improving credit quality of the issuer should drive credit spreads to fall, which results in higher valuations. We believe the same principle applies to sustainability, where an improvement in an issuer's ESG profile should, over time, translate to tighter credit spreads and lower risk premiums. The end results of holding "rising stars" from a credit or ESG perspective are similar – we should be able to achieve a reduction in credit spread and an excess return for investors.

Sustainability in action

Our Total Return strategy also follow a thematic investment approach, which often complements a sustainable investment mind-set. For example, several investment themes we have defined, such as "Demographics & Healthcare" or "Digitization & Automation", tend to score better in terms of ESG. Other themes, such as "Diversified Energy" are also at the heart of ESG issues. Today, we are presented with a historical challenge in moving from fossil fuels to renewable energy sources. Still, we believe assessing opportunities in the "Diversified Energy" theme with our "worst-out" approach is where we can make a real difference as investors – by identifying the "rising stars" and providing capital to companies that are preparing for the energy transition. In this area, we see many exciting value creation opportunities for those who can identify the energy companies that are better positioned to help society achieve the transition to a low-carbon world.

These companies may not be the "best-in-class" in ESG terms today, but show tangible signs in making significant progress.

Exhibit 1: Our Sustainability Matrix and the "worst-out" approach



JSS ESG A-Rated (Best-In-Class) JSS ESG B-Rated JSS ESG C-Rated (Worst-Out)

Companies with controversial business activities are D-Rated and at the bottom of the J. Safra Sarasin Sustainability Matrix.

Source: Bank J. Safra Sarasin Ltd

More on the J. Safra Sarasin Sustainability Matrix

The sustainability analysis and corresponding rating is conducted in-house by our Sustainable Investment Research team. General and ad-hoc reviews of the sustainability rating of individual companies are updated regularly. They are performed by the respective ESG sector analyst, taking into account the input from the portfolio manager/financial analyst. These reviews can be triggered by new information. data on sustainability key issues from providers or engagements, or a spike in new controversies.

ESG A-rated companies are investable without any restriction.
ESG B-rated companies are also part of the investment universe, however the relevant ESG risks are addressed with more scrutiny, and where applicable. Furthermore, engagement strategies are recommended if warranted.
C-rated companies, in general, are not investable. There may be exceptional cases, where a grace period is given to exit the position following a sudden downgrade (known as the grandfather period). This is done in order to protect the overall portfolio and reduce the positions in a smart and manageable way.

As we have shown, sustainability complements our Total Return strategy well, by contributing to the mitigation of tail-risks and focusing on long-term ESG opportunities. Moreover, our sustainability investing approach helps us to better analyse sector and issuer dynamics in order to determine their growth and valuation potential, as well as any inherent risks and threats.

Applying ESG to European utilities

We have mentioned earlier how granular ESG data has become. This has allowed us to delve deeper into the three pillars of E, S, & G, analysing the key issues that are important for the respective industry or investment theme. Let us take European utilities companies as an example to illustrate our point.

In terms of environmental aspects, we consider four key issues:

- Carbon Emissions
- Water Stress
- Toxic Emissions & Waste
- Opportunities in Renewable Energy

Through our analysis, we have found several European utilities companies that score well on these key issues and remain on a positive trajectory. At the same time, utilities is a very strategic sector for countries, which can result in a fairly concentrated market with some form of state-control. This could be a challenge for dealing with the Governance aspects of utilities.

However, what is important for a portfolio manager is to first understand a company's strengths and weaknesses, as well as the risks and opportunities. This is where a tight collaboration between the portfolio manager and our ESG analysts adds value, bringing deeper and actionable insights about the relevant key issues to the portfolio manager. A continuous collaboration is also important, as identifying the trajectory of a company's ESG score relies on understanding how the underlying key issues will develop over time.

For instance, our Total Return strategy is currently invested in some bonds issued by European utilities that make above-average efforts (versus the sector) to mitigate their carbon footprint, giving us confidence that their investment cases and valuations should develop positively. This example highlights the value of integrating ESG factors with traditional financial metrics in our credit analysis.

ESG reporting – deep insights for investors

As pioneers in sustainability, with over 30 years' experience, our ESG reporting has also developed in tandem over that time. Today, we are able to offer investors an in-depth ESG portfolio reporting that provides detailed but easy-to-understand insights into the ESG characteristics of our portfolio, as well as concrete information on selected holdings. The reporting provides an assessment of aggregate portfolio ESG characteristics and performance on a range of relevant metrics. The main aim is to show how sustainable a portfolio is, and why the holdings are in our portfolio.

These days, with sustainability's popularity on the rise, terms such as "SDGs", "CO2 footprint", "climate neutral", are showing up with ever-growing frequency in the investment community. These terms, which describe highly abstract concepts, can often be confusing for investors to grasp, especially without granular data and transparency. With our in-depth ESG reporting, we aim to present some of these concepts in a transparent, tangible format for investors. This should allow them to have a solid understanding of the broad ESG topics affecting their portfolios, and also gain confidence in our sustainability expertise. With our ESG reporting, investors can tangibly see how their portfolio looks like from an ESG perspective.

J. Safra Sarasin Sustainable Asset Management's ESG Reporting

In addition to the traditional reporting with typical parameters and statistics, our ESG reporting includes:

- Portfolio overview and positioning in the Sarasin Sustainability Matrix®
- Aggregate Environmental, Social and Governance sustainability scores
- Top 10 holdings and respective ESG key issues
- Climate Change focused section with
    1. Portfolio Carbon Footprint (per sector and top contributor holdings and their mitigation efforts)
    2. Carbon Intensity (per sector)
    3. Stranded Assets Risk (fossil fuel reserves exposure and claim on coal, oil and natural gas emissions)
- Controversy monitor: negative news and reputational risk measurement
- Impact monitor (SDG reporting): revenue from products and services contributing to the UN Sustainable Development Goals of portfolio companies including top contributors

At the same time, our ESG reporting gives a taste of the analysis, information, and insights that our portfolio managers have available from our sustainability research. This allows them to make better-informed decisions based on more holistic information, thereby creating added value for our investors.

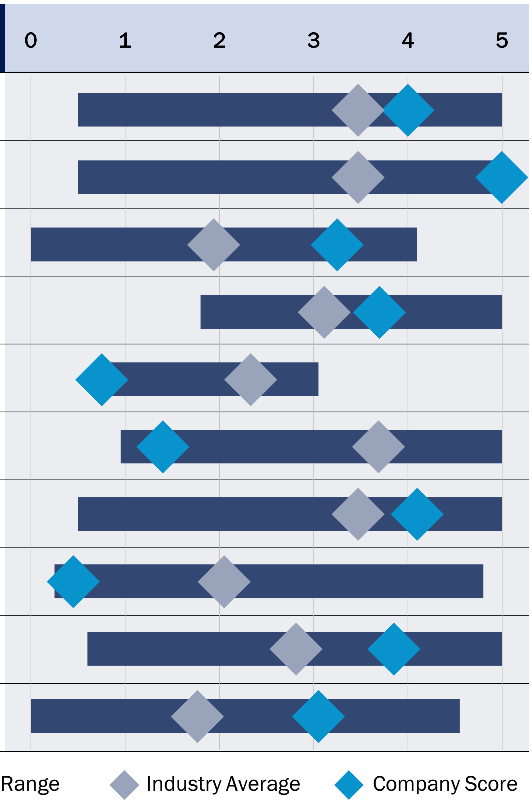
Our ESG reporting also allows us to target engagement with companies where necessary. J. Safra Sarasin Sustainable Asset Management participates in collective engagements or working groups, by joining forces with other investors to enter into dialogue with companies on ESG issues. Typically, our target companies are those in certain industries or sectors where a particular sustainability-related concern exists. It could also be an individual company with specific ESG concerns flagged as a result of our sustainability research and monitoring. In the case of Total Return, the portfolio managers or sustainability analysts can decide to engage with companies where necessary, depending as well on trigger points related to the particular investment cases. Relevant KPIs (key performance indicators) that address sustainability risks and opportunities are set in relation to the company's situation, which allows the investment and sustainability teams to monitor if and when engagement with a company is needed.

In summary, combining sustainability with Total Return investing brings added value as it helps to identify and mitigate risks early-on, while spotting emerging trends to capture attractive opportunities, to integrate ESG into our Total Return process, we adopt a "worst-out" approach. This gives us a fairly large investible universe, while providing the flexibility to invest in "rising stars" – issuers that may not be the "best-in-class" in terms of sustainability today, but show tangible signs in making significant improvements in the near future. Ultimately, we are convinced that sustainability elevates our disciplined, flexible, and non-benchmarked global Total Return strategy to the next level.

Exhibit 2: ESG reporting examples

Top 10 corporate holdings and selected key ESG issues

Name	Industry	Key Issue
International Finance Corp.	Supranationals & Development Banks	Financing Environmental Impact
International Bank for Reconstruction and Development	Supranationals & Development Banks	Financing Environmental Impact
Deutsche Lufthansa AG	Airlines	Carbon Emissions
VMware Inc.	Systems Software	Privacy & Data Security
Wallgreens Boots Alliance Inc.	Drug Retail	Product Safety & Quality
CVS Health Corp.	Health Care Services	Product Safety & Quality
Asian Infrastructure Investment Bank	Supranationals & Development Banks	Financing Environmental Impact
Cheniere Energy Partners L.P.	Oil & Gas Storage & Transportation	Carbon Emissions
Ball Corp.	Metal & Glass Containers	Packaging Materials & Waste
Western Digital Corp.	Technology Hardware, Storage & Peripherals	Electronic Waste



Top 10 corporate contributors to the portfolio's CO_2 footprint

Name	Industry	Contribution in % to CO_2-Footprint	Footprint Mitigation Efforts
Deutsche Lufthansa AG	Airlines	42.30	Above Average
CEMEX, Sociedad Anonima Bursatil de Capital Variable	Construction Materials	11.59	Average
Solvay SA	Diversified Chemicals	8.18	Above Average
Enel S.p.A.	Electric Utilities	5.48	Above Average
EDP - Energias de Portugal, S.A.	Electric Utilities	5.26	Above Average
Marathon Petroleum Corporation	Oil & Gas Refining & Marketing	4.44	Below Average
Total SE	Integrated Oil & Gas	3.66	Above Average
Eni S.p.A.	Integrated Oil & Gas	3.10	Above Average
FedEx Corporation	Air Freight & Logistics	2.66	Above Average
Silgan Holdings Inc.	Metal & Glass Containers	2.37	Below Average

Source: Bank J. Safra Sarasin Ltd, as of 30.04.2021. Allocations are subject to change without notice.

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