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ESG in (Advisory) Portfolios: FAQ

The increasing popularity of ESG (Environmental, Social and Governance) and Impact investing over the past quarters has shifted attention to companies and investment solutions with strong ESG credentials. This trend resulted in increasing number of requests on this topic reaching External Asset Managers (EAMs) from their clients.

As the topic of sustainability gains more importance in advising clients, many EAMs are positioning themselves in the market by building an ESG offering and integrating an ESG approach into the proprietary investment and advisory process. For many EAMs we have been speaking to over the past few months on the back of our first article “Demand is growing for ESG investment. What does this mean for asset Managers?” the ESG integration has three main goals: First, live up to ESG standards as a firm; second, catering to a second-generation clientele, and third, proactively differentiate their value proposition in the market from competitors.

As our client discussions repeatedly touched on the same key topics, we summarized the frequently asked questions in this follow up article.

FAQ from EAM

Q1
How shall **client preferences** be captured and recorded?

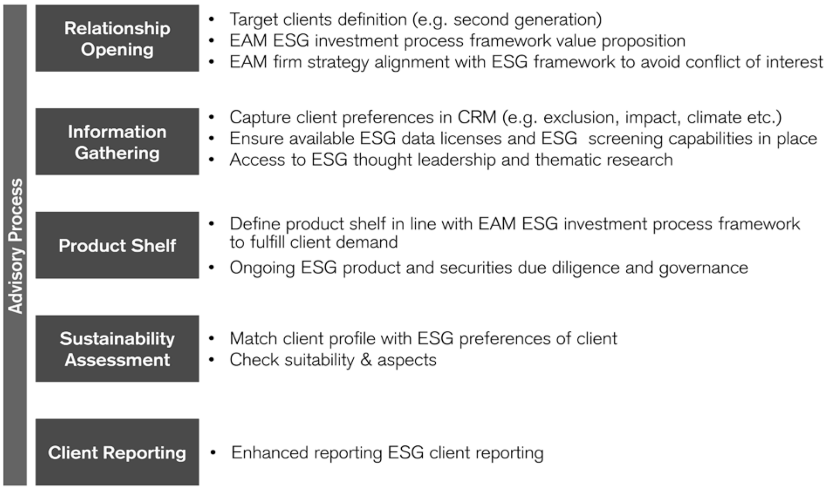
Given the individual nature of the topic, many end-clients have a different understanding of how they want to have ESG handled in their portfolios. In order to avoid misselling or disappointments we encourage to record specific client preferences, store them in their (client) profiles and regularly update these (including recording when preferences changed) in order to ensure ongoing compliance with client preferences.

In a minimal format these question should cover the following aspects:

- The clients’ general importance of ESG in an investment context
- The clients’ focus within ESG (i.e. environmental, social or governance)
- The clients’ understanding of ESG investing (i.e. exclusions of certain themes, inclusion or thematic/impact focus).

This information needs to be systematically captured before providing investment advice. More detailed questionnaires that, for instance, define criteria for exclusion of certain business practices or minimum standards for companies to be included, can be helpful particularly when it comes to determine thresholds and more specific client requirements. The recording of preferences should be aligned with the type of ESG data transparency that is available to the EAM in the market (see also Q2).

Checklist along ESG Advisory Process for EAMs



(this list is not exhaustive, serves to be a guideline and might not all need to be fulfilled)

Q2
How can ESG data be integrated in an advisory process?

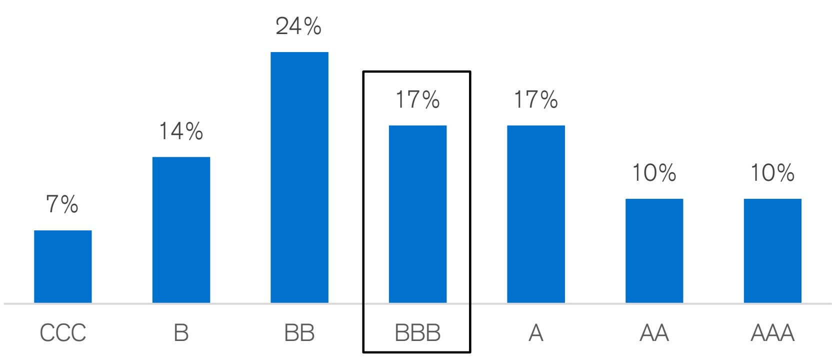
There is a number of ESG data providers in the market with a broad range of ESG rating methodologies highlighting different sub categories of a sustainability assessment.

These different sub-categories can be used to ensure that your client portfolios are aligned with the respective client's understanding of ESG investing and preferences (e.g. define thresholds, exclusions etc.). In addition, they also allow to have a structured discussion around ESG and ESG-related risks or to provide more information on specific sub-segments (e.g. carbon profile of portfolio) for your client.

Depending on the data type there are different ways to integrate ESG into the advisory process:

1. The most common data type is a **rating** for individual securities (for example similar to a credit rating ranging from AAA – very good to CCC – very bad). This approach is a good starting point to discuss an existing portfolio:
   The advantage is that it allows aggregating the ratings (similar as with credit ratings) on a portfolio level and provide a portfolio ESG rating. This allows for comparison with the broad market or with alternative portfolios.
   Furthermore, it is usually possible to decompose the rating into the different sub-ratings (e.g. environmental, social or governance or even on a deeper level) allowing for a more targeted discussion with the client. Focusing on the laggards within a portfolio can be a good first step in understanding the ESG-related risks in the portfolio.

Chart 1: Comparison of a specific company's ESG rating with its peers
Universe: MSCI ACWI index constituents, Integrated oil & Gas, n=29



Source: Credit Suisse, MSCI

2. Reported **controversies** is another element to steer the discussion of existing portfolio s to potential risks. These can be seen as a "red flag" for companies involved in specific events (e.g. major oil spill, lawsuits etc.). Some of these

controversies are backward looking and may not have an impact on the companies in the future but screening the portfolio for severe controversies can help to uncover risks or issues a client does not want to be exposed to.

3. Another approach is to measure **business exposure** to certain areas (e.g. weapons production, animal testing, etc.) and then exclude companies with exposure above a certain threshold. Given that in this case the investible universe is being restricted, this would usually be an approach to use in the early stage of portfolio construction. Such exclusions cater to value- or norms-based investors and are very individual (see Q1 regarding recording of client preferences), but in most cases they can be applied in a straight forward process and can be easily mapped to some client preferences. Access to data is critical, in particular if some less easy to monitor activities (like animal testing) shall be included.
4. The fourth approach of how to implement ESG data in an advisory process is to **measure the impact,** which is generated by a portfolio. Impact can be defined broadly by measuring the exposure of portfolio holdings to the 17 United Nations Sustainable Development Goals (SDGs) or more specifically by for example focusing on the issue of climate change. Given that in most cases the impact is not a financial measure, it is not straight forward to be measured and again access to relevant data is key.

One common aspect of all approaches is its dependency on access to a broad set of detailed and high quality (i.e. correct, current and accurate) data. Some high-level rating data is available for free by some providers. Often these high level data points do not allow for an educated client discussion and do not provide the required transparency for a specific ESG related investment decision, additional licenses or services are then required.

Chart 2: Sufficient data breadth and depth is key to lead meaningful client discussion: Example of company drill down relative to peers:

Source: Credit Suisse, MSCI

Q3
How can funds in a portfolio be assessed?

If pooled investment products such as mutual funds are part of a client portfolio, it is important to bear in mind what type of transparency can be provided. There are two main approaches: The first approach relies on aggregate portfolio data of a fund on a look through basis. In this scenario the fund provider must allow access to recent portfolio holding data, which are then assessed and aggregated. This approach on its own does not ensure that the suggested fund will always be compliant with the client's ESG requirements once the fund manager trades positions. A clear commitment by the fund manager is needed. Furthermore, some managers do not provide holding data or use derivatives positions that cannot be properly mapped to the ESG rating framework. In such case we would exclude the fund from the assessment and clearly state it to the client.

The second approach does not consider the individual holdings of a fund but looks at its overall ESG label or declaration of the fund manager. While this approach allows for an assessment with little effort on a fund level, it may overlook specific client ESG preferences and complicates a full portfolio analysis.
New regulation is aiming to increase ESG transparency by funds: According to the European Union's Sustainable Financial Disclosure Regulation (SFDR) a fund has to label itself according to article 6 (fund does not use ESG), article 8 (fund promotes ESG characteristics) or article 9 (products targeting sustainable investments). This high-level labels can help where more detailed data is not available.

Q4
What do I need to rate **my own portfolio?**

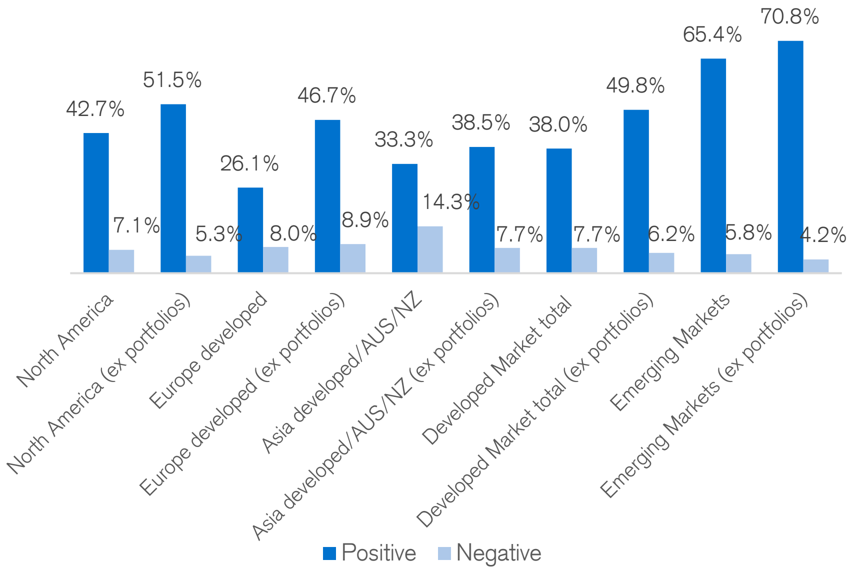
As a first step, investors need to establish a sustainable investment framework that clearly outlines what they understand under “sustainable investing” and how they intend to integrate it into their investment process (see Q2). Having a structural approach in place helps to navigate financial markets and client conversations.

Once the investor has decided on the framework and approach to follow, there are various ESG rating providers available. Ratings are assigned to individual holdings and aggregated on a portfolio level. Similarly, for funds ratings are assigned to the underlying holdings and aggregated on a fund level. This necessitates that one has transparency into the fund holdings.

Q5
What is important when assessing **EM assets** in an ESG context?

In general, companies in Emerging Markets tend to report less about their ESG related efforts. Therefore, in certain markets data quality can be an issue. However, studies show that applying ESG metrics to select EM assets can add value as it reduces risk in a portfolio especially by ensuring improved governance standards (Source: Gunnar Friede, Timo Busch and Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance and Investment).

Chart 3: relation between ESG criteria and corporate financial performance (CFP) in academic studies: ESG-CFP relation in various regions (vote-count studies sample), n=402 net studies



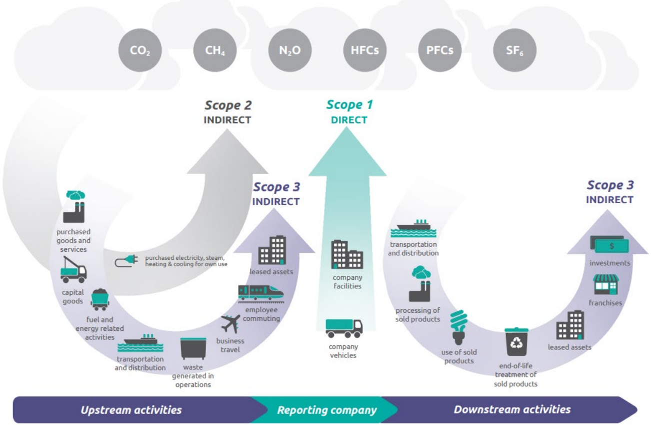
Source: G. Friede et al.

Q6
What measures of Carbon emission are most frequently used?

Most commonly, carbon intensity is used to measure the carbon emissions of a company. Carbon intensity measures how much carbon emissions per dollar of sales are generated by a company and adjusts for company size. However, carbon intensity is a backward-looking metric as only previous carbon emissions are factored in. Therefore, certain providers also developed proprietary methodologies, which measure how well a company is prepared for a world in which high carbon emissions are more and more scrutinized.

When looking at carbon emission disclosures, one needs to understand which types of emissions are reflected in the data. The Greenhouse Gas Protocol distinguishes between three types of carbon emissions. Scope 1 are direct emissions from company-owned resources, e.g. vehicles used by the company. Scope 2 accounts for indirect emissions from the company’s energy purchases. Scope 3 is everything else that is linked to a company but not accounted for as scope 1 and 2. These include the supply chain and use of products produced amongst other things. Data on Scope 3 has generally less quality as the reporting infrastructure for companies is not yet in place.

Chart 4: 3 scopes of carbon emissions (according to the Greenhouse Gas Protocol)



Source: Credit Suisse, MSCI

Q7
What are SDGs and are they measured?

The 17 UN Sustainable Development Goals (SDGs) agreed to by 193 countries in 2015 with a target date for delivery of 2030. The SDGs aim to foster collaboration within and between international private and public stakeholders to address critical global challenges such as poverty, inequality, climate change, environmental degradation, peace and justice. Certain ESG data provider in the market offer data, which shows whether a certain company is aligned with specific SDGs or even misaligned.

Q8
How to treat sectors with inherent exposure to climate harming industries (e.g. autos)

In general, companies within sectors with inherent exposure to climate harming industries tend to have a lower overall rating. However, rating providers usually construct their rating by comparing the ESG measures of a company to its peers. This allows selecting the ESG leaders within a sector, which should be prepared best for the ongoing economic and regulatory shifts we see, induced by ESG considerations.

Q9
Companies that were affected by controversies, how to deal with them

Controversies often hint at the fact that governance practices at the specific companies are not adequately implemented. Therefore, it is important to review the company in detail and to determine whether an investment is still warranted and whether the controversy is material. Rating providers factor in controversies in their ratings and regularly check for updates regarding the ongoing controversy cases. A company needs to initiate significant steps to make sure that such an event cannot happen again and to settle its open lawsuits to improve its rating again.

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SUIB 07.2021