



From theory to practice:

How SASB standards and tools inform UBS Asset Management's fundamental equity valuation

Introduction

With roughly USD 670 billion in assets under management as of September 30, 2016, UBS Asset Management offers a comprehensive range of active and passive investment styles and strategies across both traditional and alternative asset classes and markets designed to meet your needs. In particular, we have a dedicated Sustainable Investors team that manages about 4 billion in assets using an environmental, social and governance (ESG) integration approach.

Changes in business and societal landscapes make the inclusion of ESG data an important, complementary element of fundamental investment analysis, providing a more complete value creation picture for corporate business models and management. Leveraging material ESG information helps us make better-informed investment decisions and build better portfolios. As active investors, we believe that the adoption of standards for ESG disclosure is particularly important to the long-term effort to make markets more efficient and transparent. The standards and tools of the Sustainability Accounting Standards Board (SASB) are welcome additions to our investment decision-making landscape.

This case study illustrates how ESG considerations complement fundamental equity analysis, how we integrate ESG considerations in our equity analysis and capital allocation decisions, and how SASB informed the development of our proprietary tools used in these decisions.

Fundamental approach adapted to modern companies

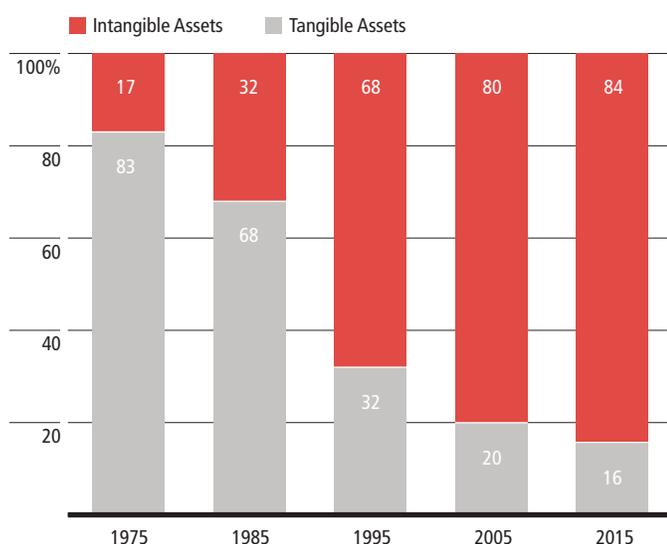
Security Analysis, the foundation for traditional financial analysis published in 1934 by Benjamin Graham and David Dodd, is still the bedrock of fundamental investment processes.¹ Published just after the Great Depression, the book introduces some of the most important concepts used in financial analysis. One concept is intrinsic value; what an investor would pay for an entire company. In 1934, intrinsic value was closely tied to the value of a company's physical assets, which were, in turn, related to book value. The other concept introduced by the book is the mosaic theory of investing; the idea that all the material fundamental data could be pieced together in a mosaic to form a "picture" of the investment opportunity.

One of the changes that has occurred over nearly a century of economic development is that the traditional concept of book value offers less insight into today's market values than it did when pioneered in the 1930s, due to several factors including the shift in the ratio of tangible to intangible asset values over

¹ Benjamin Graham, David L. Dodd, Sidney Cottle, Roger F. Murray, and Frank E. Block. 1934. *Graham and Dodd's security analysis*. New York: McGraw-Hill.

time (see Figure 1). As developed economies grew a broad range of service companies with few physical assets, and as manufacturing companies outsourced their supply chain (or even their entire manufacturing base), physical assets have become less important to a company’s value. With intangible assets accounting for over 80 percent of the market value of S&P 500 companies, and stocks trading at multiples of book value, analysts require better information on “non-financial” factors to understand what the market is paying for. Investors agree that these intangible assets have value, but traditional financial statements simply shed less light on how these assets are created, maintained and priced in the markets. “Attitude of the public towards the issue” was included among (non-financial) issues impacting the relationship between intrinsic value factors to the market price of securities by Graham and Dodd in their original 1934 work, although their fundamental equity analysis framework falls short of measuring shifts in societal attitudes.²

Figure 1: Components of S&P 500 market value



Source: Ocean Tomo, “Ocean Tomo’s Intangible Asset Market Value Study,” January 2015.

The list of environmental, social and governance factors that follows includes but a few examples drawn from today’s markets of other “non-financial” factors that have changed the value creation prospects of public companies, but for which fundamental equity analysis does not readily account:

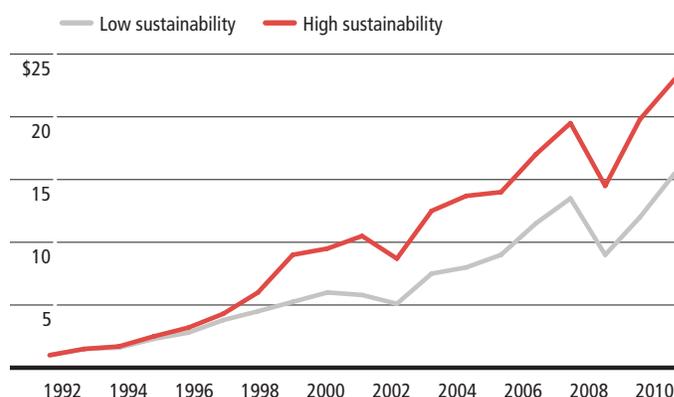
- Labor practices (e.g., the collapse of the Rana Plaza clothing factory in Bangladesh)
- Extreme weather (e.g. impacts of flooding in Thailand on chip manufacturers)
- Drought (e.g., threat of stranded bottling plant assets in Kerala, India)

² Ibid, p. 23.

Increasingly, many asset managers and a growing number of investors view ESG factors as complementary to fundamental analysis. Examining corporate performance on material ESG factors ties into financial theory to complete the picture on valuation. The integration of material sustainability factors in fundamental analysis, we believe, yields a more complete, holistic picture of a company that better informs the investment process. We do not believe that consideration of these inputs pushes aside traditional finance. Rather, we believe that they are additive to financial analysis, valuation discipline and other forms of well-accepted fundamental research in a way that is likely to result in better judgment and risk management, leading to superior returns.

Performance on sustainability issues is a corporate competence that enables improved performance and achievement of better returns for shareholders, a view supported by mounting evidence that highly sustainable companies outcompete and outperform industry peers that are less sustainable.³ (See Figure 2.)

Figure 2: Research from Harvard shows that highly sustainable companies outcompete and outperform



Note: The “High Sustainability group,” as defined by the study’s authors as companies that adopted all or most of certain environmental and social policies, outperformed the “Low Sustainability group,” as defined by companies that adopted almost none of these policies. Total sample 180 US companies. For illustrative purposes only. This does not represent the performance of any particular investment, and does not take into consideration any applicable fees, taxes or expenses. Past performance is not a reliable indicator of future returns.

Another recent Harvard study⁴ using SASB standards to classify performance data on sustainability issues found that:

- Firms performing well on *material* sustainability factors enjoy enhanced accounting **and** market returns over firms that perform poorly on such factors.

³ Robert G. Eccles, Ioannis Ioannou, and George Serafeim. “The Impact of Corporate Sustainability on Organizational Processes and Performance.” *Management Science* 60, no. 11 (November 2014): 2835-2857.

⁴ Mozaffar Khan, George Serafeim, and Aaron Yoon (2016) “Corporate Sustainability: First Evidence on Materiality.” *The Accounting Review*: (November 2016), Vol. 91, No. 6, pp. 1697-1724.

- Firms performing well on *immaterial* sustainability factors do not generate significantly different financial results than firms that perform poorly on these factors.
- Firms simultaneously performing well on *material* sustainability factors and poorly on *immaterial* sustainability factors achieve the best financial results of all.

In our view, companies that are skilled at marshaling all their assets, tangible and intangible, are more likely to: have superior supply chains that drive brand equity and pricing, attract better employees that create new products and services, have better governance that protects shareholders, and develop greater energy- and water-use efficiencies that expand margins. We believe that these skills help companies build and protect their competitive position, which competitive strategists such as Prof. Michael Porter have shown leads to higher capital returns. We believe that if we can identify these business models and invest in them at an attractive valuation we have a greater chance to deliver superior returns.

Idea generation and investment decision-making tools

Our holistic view of valuation includes non-financial factors alongside financial factors examined in a traditional valuation process. Only inputs and factors considered to be material in nature – that is, only factors that could cause the “reasonable investor” to change their capital allocation decisions – are included in this process.

Thus, SASB’s focus on materiality and the industry specificity of this focus has been very valuable to us. Specifically, SASB metrics, or KPIs, for the disclosure of material ESG factors and SASB’s Materiality Map™ have been important to the

development of our proprietary sustainability database and sustainability ranking system, which is integral to fundamental valuation portfolio construction.

This proprietary sustainability database, residing alongside the UBS Global Equity Valuation System (GEVS), is used to rank companies based on a scoring system tailored to reflect UBS Asset Management views on sustainability issues most likely to affect corporate performance. Industry-specific weightings and data generate a company-specific score that is scored into deciles with others in an industry. This complements the fundamental analysis results in the fully integrated idea generation and investment process represented in Figure 3. Securities that are attractive based on traditional fundamental analysis and achieve high rankings for sustainability performance or opportunity are eligible for capital allocation decisions on our Portfolio Optimization Platform. No explicit trade-offs are made. In other words, we do not invest in companies with high sustainability rankings but poor fundamentals, nor do we invest in attractive or cheap stocks with poor sustainability rankings.

Conclusion

We believe that this approach is fully consistent with financial theory, capital asset pricing model and our own belief in fundamental analysis. Simply put, we are striving to enhance all of the traditional fundamental analysis that we conduct with additional inputs that layer additional insight in the stock selection process. The SASB Materiality Map has been invaluable as a guide to our data gathering and investment process. See the Apple Computer example that shows our practice at work.

Figure 3: Disciplined idea generation



The Apple Computer Example

As active investors and owners of Apple stock in many strategies, when a series of articles detailing human issues in Apple's supply chain emerged in 2012,⁵ UBS Asset Management had to decide whether these issues could endanger Apple's business from both a financial and reputational perspective. Our analyst had a detailed cash flow forecast for Apple that indicated the stock price appeared to be attractively valued. And of course, as an experienced industry analyst he had a view of the company's existing and new product line and the possible effect on forward-looking earnings. The issues mentioned in the articles included hazardous working conditions, excessive overtime, improper disposal of hazardous waste, falsified records, disregard for worker's health and seeming disregard for Apple's supplier code of conduct and supplier responsibility reports. A discussion continued in the press that focused on Apple's role and responsibility for supply chain conditions, whether conditions were better or worse than competitors or Chinese industry as well as many other topics.⁶

After an internal discussion, our Sustainable Investor team decided that one way to assess the severity of the issue was to treat Apple and its supply chain as if they were a single company. We recognized that this approach was not actually how the company was structured but we reckoned that if we could gain insight on the severity of the issue on the supply chain, we would have a sense of the effect on Apple's products and brand equity.

Although the concept of materiality is not unique to SASB, the combination of the concept and a list of key performance indicators (KPIs) in SASB standards helped guide our thinking and discussion. Our analysts and portfolio managers are experienced investors with a long history of assessing the opportunities and risks in the technology sector. Nonetheless, the list of industry-specific SASB KPIs for this industry proved to be a very good guide to the most important issues we needed to consider.

Apple's supply chain is represented in the SASB Materiality Map and SASB standards within the Technology and Communications sub-segment of Electronic Manufacturing Services and ODM. The most relevant KPIs within Human Capital – those that have high financial impact – are Labor relations, fair labor practices and employee health, safety and wellbeing. In addition, three other categories are material but have lower impact: diversity and inclusion, compensation and benefits and recruitment, development and retention.

The connection between these categories and the parent company, Apple, is represented by SASB disclosure metrics for the Hardware Industry: Material sourcing and Supply chain management. This helps explain why we considered Apple and its external supply chain “as one”, because a fault in the supply chain would create a material impact on the supply chain management factor, which, in turn could have meaningful effect on product quality, brand perception and other significant intangible factors. These factors enable Apple to sell its products for a premium—according to Forbes, Apple has the most valuable brand in the world with an estimated value of \$154.1 billion.

The SASB framework was very helpful in framing the discussion between UBS Asset Management analysts, portfolio managers and the company. A list of questions for management and supply chain executives based on SASB standards and the Materiality Map helped inform our analysis and led to the conclusion that Apple was making significant steps to improve supply chain control and reduce the real and perceived risks to its brand. We also concluded that our financial analysis could be supported by this analysis of sustainability risks and opportunities, giving us increased confidence in our investment decision to hold the shares and add to our overall position.

⁵ New York Times, In China, Human Costs are Built Into an iPad, Duhigg and Barboza, January 25, 2012

⁶ Atlantic, Who's Really to Blame for Apple's Chinese Labor Problems, March 2, 2012

Disclosure

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