

MARKET REVIEW

Tapering or no tapering ?

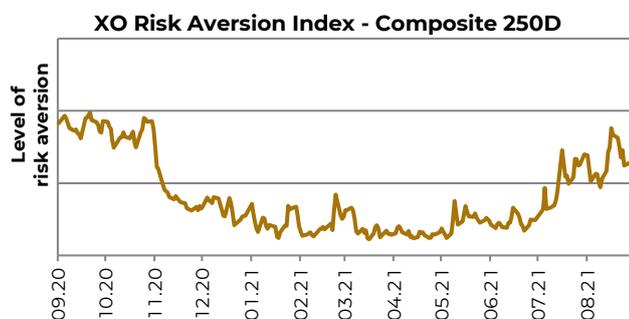
Tapering: the reduction of liquidity injections or rate hikes by central banks, is THE focus of attention at the end of the summer. As central bankers met at the end of August in Jackson Hole to discuss this issue, the FED chairman mentioned that tapering would be implemented... but not immediately. propelled the equity markets, which ended the month positively. Nevertheless, there was divergence between the Western and emerging markets.

Currencies are relatively stable while the slight increase in interest rates over the month leads to a negative performance of bonds and real estate. Bonds are the only asset class in negative territory for the year 2021.

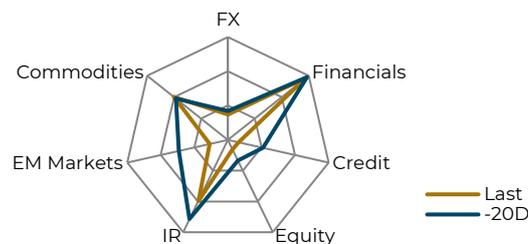
On the commodities side, oil is down 7% but remains largely profitable and still carries inflation statistics well above 2%. Finally, gold is stabilising, ending almost neutral after having fallen sharply at the beginning of the month.

Our risk indicators continue to rise on all components.

	Value	August	2021
Equity markets			
Switzerland (SMI)	12 411	2,43%	15,95%
United States (S&P500)	4 523	2,90%	20,41%
Europe (Euro Stoxx 50)	9 232	2,63%	19,97%
Japan (Nikkei)	28 090	2,95%	2,35%
China (Shanghai SE)	3 544	4,31%	2,04%
Brasil (Bovespa)	118 781	-2,48%	-0,20%
Currencies			
USD/CHF	0,916	1,10%	3,47%
EUR/CHF	1,081	0,59%	-0,02%
GBP/CHF	1,259	0,03%	4,12%
EUR/USD	1,181	-0,53%	-3,42%
Other asset classes			
Swiss Real Estate		-0,92%	6,74%
Swiss Bonds		-0,24%	-0,40%
Foreign Bonds		-0,28%	-1,23%
Commodities		-2,30%	30,40%
Oil	68,50	-7,37%	41,18%
Gold	1 814,06	-0,01%	-4,24%
Rates / Indicators			Δ
10 years Swiss rate		-0,32%	0,23%
10 years US rate		1,31%	0,40%
US Unemployment		5,40%	-1,30%
US GDP		12,20%	14,50%
US CPI		4,30%	2,70%



XO Risk Aversion Index - Components



MEASURING SUSTAINABILITY AND CREATING A SUSTAINABLE PORTFOLIO

Taking sustainability into account in portfolio management creates value but methods differ.

The sustainability jungle

Sustainability has undoubtedly been the most talked-about topic in recent quarters. All investors, especially pension funds, are now aware of this issue. Climate risks, one of the facets of sustainability, are now included by FINMA in the supervision of banks and insurance companies.

Unfortunately, the concept of sustainability is multidimensional and there is no consensus on the criteria to be used or on how to implement it in a portfolio.

However, the selection of criteria is crucial as it determines which facets of sustainability are promoted through investment. Generally speaking, sustainability is separated into three areas:

- › Environmental (E): the impact of the company on the ecosystem;
- › Social (S): the company's relationship with employees, customers and the community;
- Governance (G): the system that encourages the company to work in the long term for the benefit of its stakeholders.

These three areas, from which the acronym ESG originates, are extremely broad. It is therefore possible to narrow the field of action by selecting specific criteria such as climate protection or the promotion of human rights.

Examples of ESG criteria

Environment	Social	Governance
Climate protection	Relations with communities	Shareholder rights
Biodiversity	Consumer protection	Composition of turnover
Pollution	Human rights	Compensation policy
Eco-innovation	Employee health	Frauds, corruption, ...

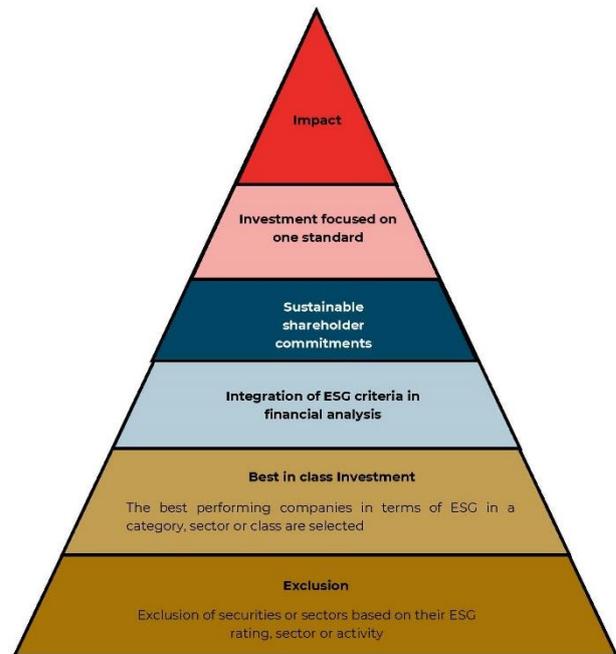
Source : XO Investments SA

Once you have selected the aspects you wish to promote, you need to consider how to promote them, i.e. the implementation within the portfolio.

The choice is generally dictated by the level of impact desired by the investor. An ESG pyramid can thus be drawn, ranging from exclusion

(based on criteria and ratings depending on the data provider) to the desire for impact.

ESG pyramid



Source : XO Investments SA

From governance to decarbonisation

Sustainable investments have changed significantly over time. Initially the area of governance received the most attention. In recent times, sustainable investments have adopted a holistic approach by considering all areas of ESG. Driven by intergovernmental initiatives (COP21, IPCC, ...) sustainable investment is now refocusing on the environmental domain and, more specifically, on climate change.

Protecting the climate through investment means reducing the carbon footprint of portfolios. A recent article looks at how best to create a decarbonised portfolio. Here we present the work.

The first step is to define the measure of the carbon footprint. Three measures are used for this.

The first is done by identifying the company's direct emissions at its production sites (e.g. the release of CO₂ from the combustion of a machine engine, these are scope 1 emissions) and indirect emissions such as the generation of

emissions from the use of electricity or heating (scope 2 emissions). These scope 1 and 2 emissions are relatively simple to calculate as they are based on figures reported by companies. The aggregation of direct and indirect emissions is the primary metric used by the authors of the study, and can be referred to as "operational carbon efficiency" (OC).

The second measure of carbon intensity takes the first measure above and adds emissions from the value chain (upstream of production) as well as during the use of the product or service (scope 3 emissions). A total value chain carbon intensity (TVC) measure is thus estimated. Finally, the last measure of emissions is given by the ratings published by MSCI (AR). This measure has a broader scope as it is not limited to carbon emissions, but also considers other factors such as supporting measures or transparency.

The authors will compare these three measures with each other and with the returns of portfolios constructed according to these measures. The study covers a sample of 1002 US companies between 2013 and 2020 representing 80% of the US market capitalisation.

The Marked Sectoral Differences

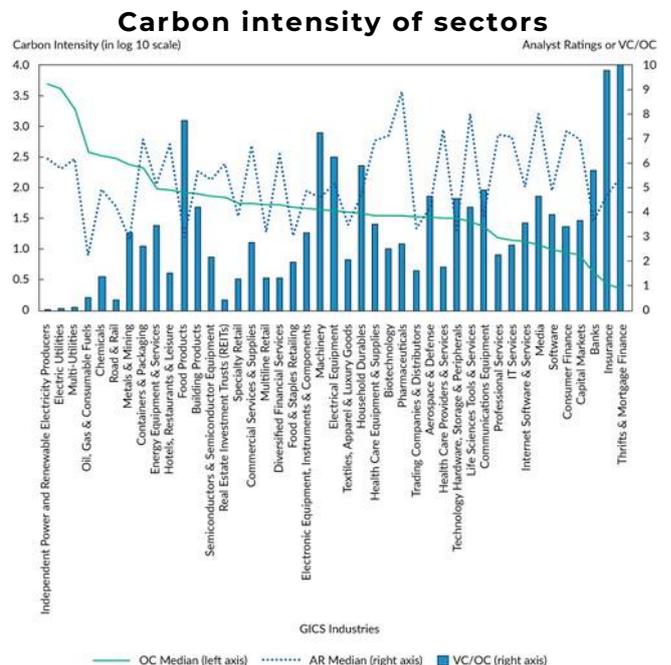
The first result of the study concerns the industrial sectors. The authors compare the three measures (OC, TVC and AR) for each of the industrial sectors. This allows the granularity of the three measures to be checked. Unsurprisingly, sectors such as power generation, e.g. coal-fired power plants, show the highest carbon intensities (CO). This is shown in the following graph by the green line (left vertical axis).

When analysing scope 3, i.e. the integration of the entire value chain in the measurement of carbon intensity (blue bars), sectors such as machinery, insurance or food produce much more carbon than their production alone (scope 1 and 2) would suggest. These industries therefore demand that investors look at the whole value chain and not only at the production of the company itself.

Finally, analyst ratings (blue dotted line) tend to rate industries with low total value chain emissions better and vice versa. This indicates that analysts, in order to provide comparable ratings across industries, need to integrate aggregated data at the industry level. This has the side effect of smoothing out differences

between companies operating in the same industry.

The three measures give homogeneous results while having a different depth.



Source : « Decarbonizing Everything », CFA Institute

Decarbonised portfolios

The next step in the study is to create the most decarbonised portfolio on each of the three measures used. The creation of this portfolio consists of buying the best companies in each sector and selling a portfolio that would have the lowest rated companies in each sector. This "Long/Short" approach allows for the "abnormal" performance, i.e. excess or short of an investment in an index.

Performance for decarbonisation factors

Measure	CO	TVC	AR
<i>1. Carbone Intensity</i>			
Intensity CO	-209	-190	-62
Intensity TVC	-362	-382	-100
<i>2. Performance</i>			
Annual Return	2.34%	1.50%	0.76%
Risk	3.20%	3.27%	4.59%
Sharpe ratio	0.73	0.46	0.17
<i>3. Multifactors regression</i>			
Alpha	1.70%	0.77%	1.63%
	(1.87)	(0.87)	(1.42)

Source : Decarbonizing Everything, Financial Analysts Journal

The first results concern carbon emissions. For each of the portfolios studied, carbon emissions

are significantly reduced as shown in the first two rows of the table above. The reduction is greater when using the OC measure, i.e. the company's scope 1 and 2 emissions, or the emissions of the entire value chain, rather than using the analysts' ratings. This result is expected as analysts do not base their ratings solely on scope 1 and 2 emissions.

In terms of performance, if the measure used to create the portfolio is the company's carbon intensity (CO₂), the annual excess return is 2.34%. Thus, by focusing on companies with the lowest carbon emissions, the result is a portfolio that generates a higher return than the market. This is the best result in the sample. It shows that taking environmental criteria into account adds value to the portfolio. The result is positive but lower for TVC and even lower for the analyst ratings (AR). The latter portfolio also appears to be the riskiest.

The two measures OC and TVC offer the best Sharpe ratios, i.e. the best return per unit of risk taken. Finally, the alpha (risk-adjusted performance) is large and significant for the OC measure.

The authors go on to show that the dispersion in carbon emissions of companies within a sector is significantly greater in industries that are materially more impacted by climate change. Unfortunately, this finding is not confirmed if analyst ratings are used as a measure. The reason for this is likely to be that analysts are less likely to differentiate between industries within

a very high carbon sector and tend to incorrectly rate all companies in the sector.

The results found above are more robust in the most polluting sectors and the portfolios generate higher performance. This is a sign that sustainability within companies has become an indispensable factor in stock selection.

Marked sectoral differences

The article gives us a few avenues that bring concrete value to investors. The measurement of a company's direct and indirect emissions, or the consideration of emissions across the value chain, seem to be the best measures to use in this context. The ratings produced by analysts also lead to lower emissions and better portfolio performance, but to a lesser extent.

The results therefore depend on the measures used. Indeed, the measurement of sustainability is a concept on which scientists and analysts are still pondering on. The multiplicity of possible criteria and heterogeneous data make it difficult to establish stable models for creating a sustainable portfolio.

Even if sustainability has become established in asset management, it will take time for the methodologies to stabilise. Several institutions are working on establishing standards for the disclosure of key figures, as is done for accounting figures. In the coming years, these standards will help to reduce complexity and promote the consistent implementation of sustainable portfolios.