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EXECUTIVE SUMMARY

Sustainable Investing—Opportunity in a World of Complexities

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The coronavirus accelerates the focus on corporate sustainability

- The universe of stakeholders—shareholders, bondholders, regulators, employees—are all pushing in the same direction on sustainability, and companies that ignore this powerful secular force are going to be left behind.
- Certainly, from an equity market perspective, the focus has been accelerated. Sustainability has assumed an even greater resonance in 2020, and we are seeing some companies starting to actively address pressure points. This is evident across the digital spectrum, for example, with technology enabling innovation in areas like online education and medical research.
- In bond markets specifically, companies that are unable to clearly articulate their sustainability strategy will ultimately face higher capital costs, which will impact their ability to fund capital projects and also the rate at which they can refinance their debt.

Is there a trade-off in terms of making a business more sustainable?

- In many ways, there really isn't a trade-off at all—companies either manage for a sustainable future or risk brand damage or, worse, potential oblivion. This is the extreme, but it is also the clear direction of focus.
- As to whether all companies can make the transition, it is really a question of necessity.
- Within the auto industry, for example, the tremendous success of Tesla—and the competitive threat that it poses—has forced original equipment manufacturers (OEMs) to invest significant capital in order to retool and transition their business models. For these businesses, the trade-off is the cost involved in making the transition. But if they are not prepared to make this investment, there is a real risk that they will cease to exist altogether in 20 to 30 years.

Signs for companies that are "greenwashing" their narratives or actual debt issues

- Instances of greenwashing are not rampant, but they do occur in the rapidly growing area of green bonds.
- Certainly, not all green bonds are created equal, and there is wide variation in terms of quality and standards. While some bonds may technically be green, there is little consideration given to covenants or protections to ensure that the issuer follows through on its stated commitments.
- We spend a lot of time analyzing green bond issues on an individual basis to ensure that we can credibly track the proceeds back to the stated project or objective. We also look for senior management sponsorship and oversight to gain comfort that there is executive accountability behind the issue. More broadly, we also need to understand the issuing companies' broader ESG strategies—are they credible, ambitious, and realistic?

ESG integration into investment decisions: Is it a potential driver of performance or a mitigating risk?

- In the past, ESG factors have largely been considered from a risk mitigation perspective. And this aspect is very important, as this nonfinancial information helps to identify truly bad actors from an ESG perspective.
- However, in today's markets, ESG is becoming increasingly mainstream, providing opportunities that are on the right side of sustainable change. Using ESG factors to determine those companies that are delivering positive social and environmental impacts can provide very real opportunities to generate alpha.
- Microfinance companies are a good example of this alpha potential. These businesses are having a positive social impact by enabling wider financial inclusion, particularly at the bottom of the social pyramid. In India, for example, microfinance providers are enabling rural customers to access finance, and they are allowing women, in particular, to enter the business domain. Charging loan rates of around 15% to 20%, these companies are not only empowering entire communities, but also generating a decent return for underwriting the risk.

Measuring the impact of ESG factors within a portfolio

- On the fixed income side, we look to measure this impact via our process—by ensuring the robustness of our screening criteria, which is connected to our impact investment pillars, which are, in turn, connected to the UN Sustainable Development Goals (SDGs).
- In terms of screening criteria for any bond we invest in, at least 50% of the issuer's revenue, either today or at some defined point in the future, must be directly linked to our impact investment pillars and, in turn, to the SDGs. We are constantly retesting these links to ensure the integrity of our process.
- On the equity side, we adhere to the same clearly defined impact framework, which details whether or not the majority of a company's revenues, either today or in the future, are directly linked to one of the three investment pillars.

What are the potential opportunities presented by the evolving ESG landscape?

- As major bond market investors, we are in a position of being able to help finance the drive toward sustainability and positive change. Given the importance of ESG and the fact that new issuances and new issuers are coming to market, covering new sectors, there is a tremendous opportunity to drive positive change over time, in terms of scale and impact.
- These sentiments are echoed on the equity side. It is a great privilege to be part of the journey, where we can actually channel capital toward solving many of the sustainable pressure points that exist today. More specifically, the rapid and urgent change that is taking place in renewable energy and the decarbonization of the economy are certainly causes for excitement. In health care, as well, the emphasis on social impact and improving the quality of life are also very exciting. We are focused on companies that can reduce the cost of health care and that can deliver lifesaving solutions and drugs to the market.
- Finally, from a social impact perspective, we are really excited about the journey that many companies will take over the next 10 to 20 years to improve gender and ethnic diversity and inclusivity. We will continue to focus on investing in those company leaders and management teams that prioritize and enable this change.

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