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SUSTAINABLE INVESTING OUTLOOK: PRIMARY CONSIDERATIONS FOR 2022

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> Sustainable investing is first and foremost about helping investors with their financial goals. Unlike conventional investors, sustainable investors can also provide additional benefits by signaling that responsible corporate behavior matters. Sustainable investors hold companies accountable for improving environmental, social, and governance (ESG) performance while providing capital to undersupplied markets.

Increasingly, investors are taking ESG considerations into account when evaluating the risks, opportunities, and value alignment of their investment portfolios. The mainstreaming of sustainable investing continued throughout 2021, as sustainable investing funds attracted record inflows and continued to perform well, and sustainability issues, such as climate change and workplace diversity, were top priorities for both companies and regulators.

Building off another strong year during 2021, we expect sustainable investing 1) to continue to attract investors new to the approach, 2) to provide competitive financial performance, and 3) to provide investors stewardship opportunities.

1. ATTRACTING INVESTORS NEW TO THE APPROACH

Many investors still do not know about sustainable investing and some advisors are reluctant to bring it up, but that is changing. Organizations such as the Forum for Sustainable and Responsible Investment (US SIF) offer a free introductory course for individual investors that want to learn the basics of sustainable investing.[1]

What they will find is that sustainable investing has evolved remarkably over the last half century. A journey that began in the early 1970s as a simple portfolio construction process to avoid certain investments has grown into a broad range of investment methods that include ESG considerations throughout the investment decision-making process. This evolution has been enhanced by an increase in corporate ESG disclosures, which has enabled new investment methods to emerge. While fewer than 20 companies disclosed ESG information in the early 1990s, nearly 9,000 companies were providing this data by 2016. This increased transparency has allowed asset managers to identify best-in-class companies based on ESG risks and opportunities.

Sustainable investing is not a one-size-fits-all approach as interest varies by investor. Motivations for sustainable investing can be grouped into values alignment, financial performance, and impact. For investors, the place to start is to understand their own motivations for their interest in sustainable investing. Once that is clear, motivations can then be mapped to one or all of the outcomes. Finding a strategy or two, becoming more aware of various approaches, and slowly increasing one's exposure to sustainable investing is a common way to get started.

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[1] Sustainable Investing: An Introductory Course for Individual Investors US SIF https://www.ussif.org/courses
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Act to Avoid Harm: Values Alignment

- Some investors are motivated by the awareness that their capital should align with responsible corporate behavior. These investors seek to act to avoid harm, primarily through an investment method that excludes certain investments from a portfolio in order to align values.
    - Example: Investors can signal that responsible corporate behavior matters.
        - *"I don't want to support companies that harm the environment, violate human rights, or engage in unfair labor practices."*

Benefit Stakeholders: Financial Performance

- Other investors see sustainable investing as a way to unlock commercial value, such as backing companies with strong ESG practices that are better positioned to adapt to a changing world. These investors seek to identify companies that provide benefits to all stakeholders, including workers, customers, and their supply chain, primarily through the methods of ESG integration and stewardship. These methods intentionally consider the role of ESG factors in building a strong business alongside traditional financial analysis to identify ESG risks and opportunities.
    - Example: Investors can engage actively to improve ESG performance of companies.
        - *"I want companies to have a positive effect on society."*

Contribute to Solutions: Impact

- Another group of investors is motivated to create positive change. These investors seek to invest in a way that has a measureable impact.
    - Example: Investors can supply capital to underserved communities.
        - *"I want to help tackle the affordable housing gap."*

The above outcomes are known as the A-B-C Framework (avoid, benefit, contribute).[2] This framework helps align investment methods, expected outcomes, and progress assessments.

A-B-C Framework

2. DISCUSSING FINANCIAL PERFORMANCE

Surveys show that one of the largest barriers to adopting a sustainable investing approach is the misperception that one must sacrifice investment performance. Although numerous academic studies have been written on this topic, with most agreeing that sustainable investing rarely had a negative impact on financial performance, the concern remains.

It is important to stress that not all sustainable investing methods are the same, as a strategy centered on excluding certain stocks based upon personal values executed by an inexperienced asset manager will have different

[2] Impact Management Project. How Investors Manage Impact. https://impactmanagementproject.com/impact-management/how-investors-manage-impact/

outcomes than a method based upon ESG integration executed by an experienced asset manager. Investors that choose to place heavy restrictions on their portfolios' holdings will have financial performance results that differ from investors that choose to consider financially material ESG factors alongside traditional financial analysis to identify ESG risks and opportunities.

Further, sustainable investing implementation differences can lead to different outcomes given a wide range of experience between asset managers in this evolving space. A forecast of how much a particular ESG risk factor will impact a financial metric, such as future cash flow, may differ from one asset manager to another. Frameworks, such as materiality assessments or maps, are helpful in providing some guidance to sustainable investing implementation. However, the process of forecasting ultimately leads to a spectrum of opinions, much like traditional investing approaches.

We expect sustainable investing financial performance in 2022 to remain competitive to conventional approaches. At the same time, investors should understand the potential portfolio impact of different approaches to sustainable investing so that financial performance expectations are clear in advance.

3. INVESTOR STEWARDSHIP OPPORTUNITIES

Holding companies accountable for improving ESG performance is an often overlooked benefit of sustainable investing. Engagement is the way investors apply their stewardship responsibilities, often through the asset managers who manage a strategy. Many asset managers are signatories to the UN Principles for Responsible Investment (PRI), which contains Principle 2 that states, "We will be active owners and incorporate ESG issues into our ownership policies and practices."[3]

Stewardship is the process of intervention to ensure that the value of assets is enhanced over time, or at least is not diminished due to neglect or mismanagement. Asset managers can act as stewards of the companies they own through 1) engaging with company management, 2) casting votes on an annual ballot of resolutions, and 3) proposing resolutions to be voted on by other shareholders at general shareholder meetings.

Engagement

- Engagement involves dialogue between company management and the asset manager. Through engagement, an asset manager can help hold investee companies accountable to improve their ESG performance.

Voting Shares: Management Resolutions

- By owning shares of a company, a shareholder is entitled to voting rights. Voting rights allow shareholders governance oversight, as shareholders have the right to vote on a basic set of issues at least once a year at a company's annual shareholders' meeting. The range of items for vote on the annual ballot of resolutions allows shareholders an opportunity to weigh in the on the governance and direction of the company. Since many shareholders cannot attend the meeting in person, many exercise their votes by proxy.

[3] United Nations Principles for Responsible Investment. https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment

Proposing Shareholder Resolutions

- Shareholders may also propose resolutions to be included on the ballot to be voted on by all shareholders. The filing of a shareholder proposal may facilitate dialogue and may result in the shareholder withdrawing their previous resolutions if management acts. Shareholder proposals addressing ESG risks have a long history, first appearing in 1969 with a resolution requesting Dow Chemical stop the sale of napalm to the U.S. government.
- During the 2021 proxy season, 435 shareholder resolutions on ESG issues were filed, up from 429 the year before, with climate change, workplace diversity, and political lobbying the three most common themes.
- We expect both climate change and workplace diversity to be key themes in 2022 as well.

Climate Change Risk

The Sustainability Accounting Standard Board (SASB) was established in 2011 to develop and disseminate sustainability accounting standards. The standards identify financially material issues, or those factors that may significantly influence a company's business model and value drivers, such as sales, profits, and expenditures, and therefore are most important to investors. Climate change risk and greenhouse gas (GHG) emissions are two of the 26 financially material general sustainability issues identified by SASB.

Over the last couple of years, governments and corporations have made commitments to achieve net-zero GHG emissions by 2050, or sooner. By committing to net-zero, these entities pledge to achieve balance between the GHG emissions produced and those removed through offsets, such as carbon removal or tree planting. The growing list seeks to deliver on the goals of the Paris Agreement, which aims to limit global temperature increase by 1.5°C and halve carbon dioxide emissions by 2030 and reach net-zero by 2050, or sooner. We expect more pledges in 2022 in order to arrive at a global net-zero scenario.

An almost $4 trillion annual investment into clean energy is required by 2030 to meet the Paris Agreement pledge.[4] The amount of capital needed, the fast moving landscape, and the complexity of the interconnected demands enables investors to tackle these challenges in ways governments cannot. To help channel assets towards needed solutions, investor groups such as UN-convened Net Zero Asset Owner Alliance and the Net Zero Asset Managers Initiative (NZAM) have recently been created. Both set out a range of actions investors should take to align their portfolios with a net-zero commitment. Asset owners and asset managers will be able to take multiple actions toward climate change goals, including divestment, stewardship, and investment in climate solutions. Collaboration on climate-related stewardship activities will be led by organizations such as Climate Action 100+, which is leading efforts on improving climate change governance, cutting emissions, and strengthening financial disclosures. Looking ahead, we expect even more asset managers to join the NZAM, more engagement and shareholder disclosures in 2022, as well as the SEC to consider new climate change disclosure requirements.

Workplace Diversity

Workplace diversity is another financially material issue identified by SASB.

Following a wave of corporate commitments to action on diversity, equity, and inclusion following the murder of George Floyd in May 2020, investors sought to hold companies accountable on their commitments through engagement and shareholder resolutions. Shareholder resolutions in 2021 pushed to have companies make public the annual EEO-1 forms filed with the U.S. Equal Employment Opportunity Commission's (EEOC). The forms

[4] IEA (2021), Sustainable Recovery Tracker, IEA, Paris https://www.iea.org/reports/sustainable-recovery-tracker

classify employees by race, gender, and ethnicity in standardized job categories and provide data that can be used to assess and compare corporate diversity performance. We expect more engagement and shareholder disclosures in 2022, as well as the SEC to consider new disclosure requirements.

Shareholder resolutions in 2021 also went beyond EEO-1 by asking for disclosure of recruitment, promotion, and retention by gender, race, and ethnicity. These proposals requested companies include disclosures on how companies assess the effectiveness of their diversity and inclusion programs. We expect further engagement and additional shareholder disclosures in 2022.

CONCLUSION

As sustainable investing continues to become mainstream, we expect it to continue to attract new investors. The wide range of motivations that bring investors to sustainable investing and the different ways investors can engage will lend added support to the rapid growth we've seen over the last several years. Further, one of the biggest barriers to sustainable investing, the misperception that one must sacrifice investment performance, has been well addressed at this point. Still, it's important to clearly set expectations with investors, especially around different levels of asset manager experience and different approaches to sustainable investing, some of which can be very restrictive. Perhaps most importantly, sustainable investing gets to the heart of what it means to be a shareholder. As owners of the business they invest in, shareholders can hold companies accountable for improving ESG performance and gives investors a path to influence important issues, such as climate change and workplace diversity, in ways that conventional investing cannot.

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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An Environmental, Social and Governance (ESG) fund's policy could cause it to perform differently compared to funds that do not have such a policy. The application of social and environmental standards may affect a fund's exposure to certain issuers, industries, sectors, and factors that may impact relative financial performance — positively or negatively — depending on whether such investments are in or out of favor.

US Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

Please read the full Outlook 2022: Passing the Baton publication for additional description and disclosure.

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