Responsible Investment Insights

Q2 2024

For professional investors only

The path to sustainability: milestones and markers

HSBC Asset Management

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Foreword

Expect progress in implementation of industry frameworks tied to climate transition and sustainability disclosures, as well as systemic risks such as preservation of natural capital, inclusive growth and responsible use of AI.

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This edition of our Responsible Investment Insights series comes amidst growing debate around how asset managers address ESG risks. It also follows important discussions facilitated late last year through Cop28 and PRI (Principles for Responsible Investment) in Person 2023. We will highlight insights we've gleaned and look ahead at key sustainability developments we expect ahead.

Tackling climate change impacts will certainly be a focal point for investor considerations for years to come. Last year's dubious distinction of being the world's hottest on record, by a wide margin, reinforces the growing need for corporations and governments to accelerate both decarbonisation and climate adaptation efforts. Addressing climate impacts already being felt was an important talking point of Cop28, resulting in 130 countries signing a declaration aimed at scaling up adaptation efforts around farming, food security and integrated management of water, as well as increasing energy efficiency.

Related to this challenge, we expect the issue of preserving and replenishing biodiversity to come to the fore now, given its role in both mitigating climate change risks and decarbonisation.

We also expect greater emphasis on broader societal considerations related to climate change. Progression of green technologies means changes to industries and jobs. Achieving a 'just transition' that doesn't leave segments of society behind is vital to avoid inequality and unrest which would pose significant risks to economies.

Of course, concerns over societal impacts from new technologies extend far beyond climate tech. Rapid developments in artificial intelligence, for instance, have driven discussions around frameworks to ensure adequate controls that safeguard public interests.

Standards and framework setters are key to driving change. Delivering transparency and accountability wherever companies operate is a key enabler of driving better information for investors. Fortunately, this is an area where progress is quickly being realised.

We took the opportunity of the gathering of leaders at PRI in Person 2023 in Asia to survey the opinions of other asset managers and asset owners for context and insights into key sustainability priorities that may affect how they allocate their capital in future. Relevant takeaways are included in this publication, which I trust you will find useful.

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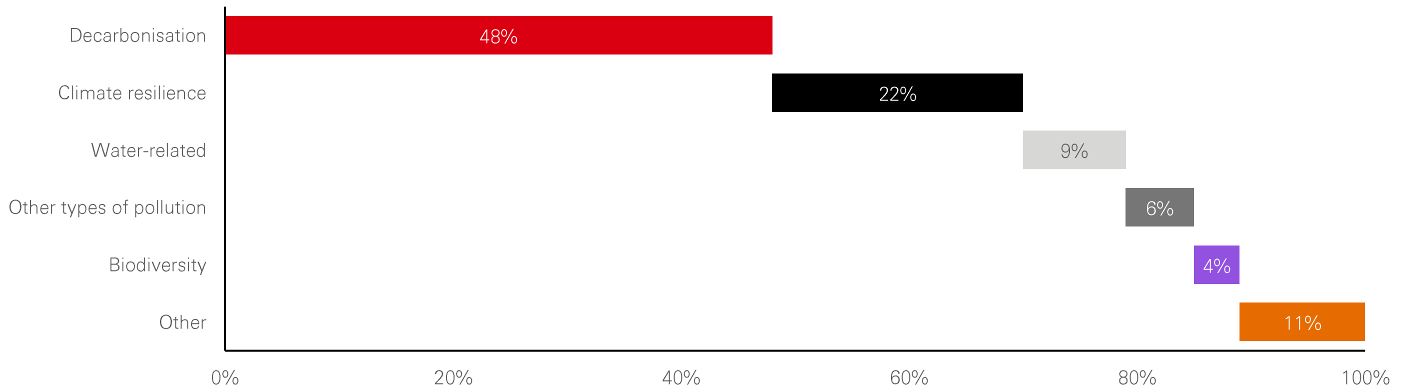
Growing but insufficient environmental investments

The Intergovernmental Panel on Climate Change has highlighted that global warming is more likely than not to surpass 1.5 ℃ by 2030, with 2023 already delivering an average temperature just shy of 1.5 ℃ warmer than pre-industrial times. Significantly reducing carbon emissions clearly remains a major issue, supporting why investors have ranked decarbonisation as the top priority in the coming year.

Figure 1: Environmental issues that investors prioritise in coming year



Source: HSBC ESG Sentiment Survey, July 2023.

Emissions reporting is an area where regulatory developments should deliver much improved clarity to investors around company impacts on climate change and corresponding transition risks. Disclosure regulation is increasing across Europe, the UK and the US. Proposed reporting standards from international standard setters such as the International Sustainability Standards Board (ISSB) are also being adopted in several Asian markets.

The addition of scope 3 disclosures has been much debated and where it is included, will enable investors to understand emissions across a company's value chain. This is significant for evaluating true impacts and risks, given the majority of corporate emissions are occurring across the extended value chain. We believe engagement will play a key role and are encouraged by building momentum for voluntary disclosures aligned with TCFD and ISSB recommendations.

> Over half of investment in climate solutions will be needed in Asia alone.

Asia currently accounts for around half of global emissions. Accordingly, the Global Financial Markets Association estimates that over half of investment in climate solutions will be needed in Asia alone. This need contributed to Asia crossing the $1 trillion milestone in cumulative issuance of impact bonds in the first quarter of last year, only trailing Europe.[1]

While Japan isn't fully representative of the economies of the broader region, we expect the country's announcement of a green transformation strategy at PRI in Person is a harbinger of more to come from the region. The strategy will cover the implementation of carbon pricing, the issuance of the country's first climate transition bond worth $130 billion, and the development of climate technology roadmaps.

Technological innovation has now provided many of the solutions that we need to limit global warming, provided ongoing investment enables them to be implemented at pace and scale. However, given the now unavoidable climate impacts ahead, a pressing need extends to increasing the level of climate technology innovation focused on adaptation strategies.

1 - OECD, September 2023

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Today, most environmental initiatives are geared towards mitigation. While these initiatives are clearly needed, per the UN environment programme's Adaptation Gap Report 2023, progress on climate adaptation is lagging when it should be accelerating to catch up with rising climate change impacts. This slowdown translates to a constantly widening adaptation financing gap, which stands at approximately $200-350 billion per year.

> The adaptation financing gap stands at roughly $200-350 billion per year.

Given the physical effects of climate change being increasingly felt, we do expect adaptation efforts to begin to accelerate in order to address growing problems such as food insecurity and water scarcity, amidst more severe weather patterns such as heat waves and droughts. Even with an acceleration in adaptation efforts, these issues will continue to present growing challenges including inflationary pressures and risks to economic growth.

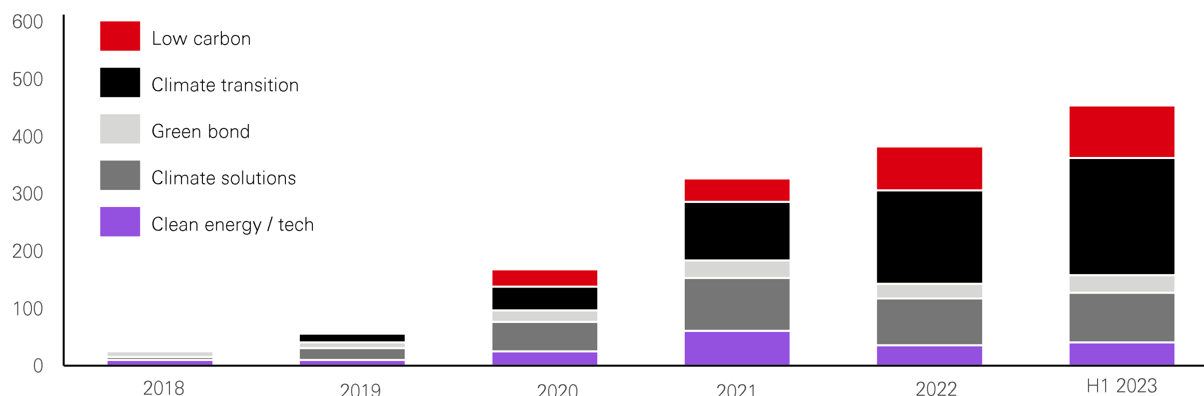
The current restrictions on cargo passing through the Panama Canal serve as an example, with severe drought and reduced water levels the cause and higher shipping costs a result. Similarly, an ongoing drought in the Mediterranean is putting extreme stress on water systems and placing crop production at risk.

Accordingly, development of effective adaptation strategies is necessary to enable vulnerable areas to manage new climate extremes. Further benefits include positive effects on biodiversity – itself a contributor to reducing greenhouse gases in the atmosphere – along with improved air quality, water management and general health and well-being.

This was a key topic at Cop28, where 130 countries signed a declaration which aims to scale up adaptation efforts to deliver more resilient food systems amongst other priorities, such as integrated management of water. It was accompanied by commitments of $2.6 billion for regenerative agriculture and innovation.

With government support, investment in the climate transition will continue its growth. Asset managers are in a position to support it through solutions that deliver capital to the relevant areas of the market. We expect to see investor priorities shift more towards climate resilience, biodiversity and related issues going forward, as government initiatives and industry breakthroughs present compelling opportunities to both address necessary change and deliver investment portfolios less exposed to the risks of climate change.

Figure 2: Growth in types of climate strategies (Assets, USD billion)



Source: HSBC Asset Management, Morningstar Direct, Morningstar Research, as of June 2023

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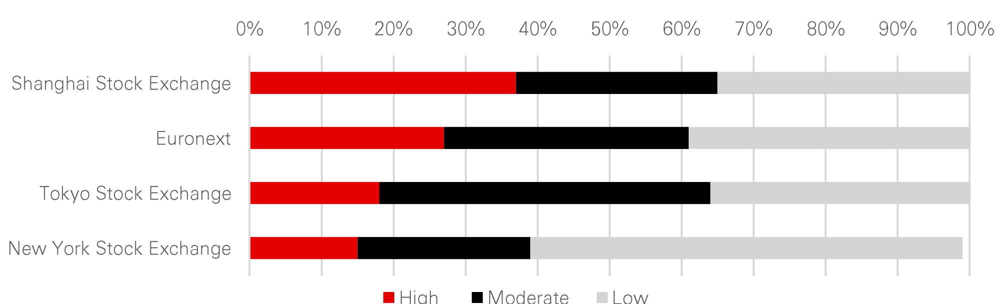
Emphasis on preserving and enhancing biodiversity is building due to the realisation that ongoing biodiversity loss is becoming a critical issue – given it both contributes to climate change and increases exposure to climate change impacts, such as flooding, by removing the land's natural defences. In 2023, a quarter of new green bond issuances were linked to natural capital projects such as biodiversity, forestry and sustainable agriculture.[2]

Economic consequences are significant, with more than half of global output having at least a moderate reliance on nature.[3] This means investor risk exposures are likewise significant. Below are PWC estimates of the market value dependence on nature for listed companies across major stock exchanges, with variations due to the mix of companies on each exchange.

Over half of the market value of companies listed on major stock exchanges is exposed to financial risk through at least moderate dependence on nature.

Figure 3: Listed market value exposed to financial risk through dependence on nature



Source: PWC, Managing nature risks: From understanding to action, April 2023

Accordingly, natural capital, or the asset of nature, is of growing importance to investors. MSCI ESG Research projects $9 billion invested in nature-based projects by 2025 through projects currently in development, demonstrating significant growth from the $16 billion invested from 2012 to 2022. New capital raises and announcements cover an additional $20 billion of investment up to 2030.
With emphasis from governments, regulators and investors, we expect companies with a material impact on nature to have greater uptake of the Taskforce for Nature-Related Financial Disclosures (TCFD) framework launched last year.

For investors looking to mitigate relevant risks in their portfolio, nature-related data remains a key challenge. However, regulations are being introduced to identify these risks, such as the EU Deforestation Regulation, which requires companies to inform investors of their climate and deforestation risk exposures. Further EU regulations set to enter into application at the end of 2024 will also require verification that products sold in the EU don't contain commodities produced on recently deforested land.

Alongside regulatory requirements forcing change, technology can support. Databases leveraging satellite imagery, for instance, can be utilised to identify companies with higher degrees of exposure to, or impact on, biodiversity risks.

Japan's launch of its first transition bond underlines the role of financial instruments in supporting nature-related priorities. The proceeds of the bond will primarily fund development of clean energy and transport technologies, along with the development of natural carbon sinks, such as reforestation. Efforts to restore wetlands and peatlands, which can absorb roughly half of the CO_2 emissions humanity generates, have been particularly advocated for by the TCFD.

2 - MSCI ESG Research, Sustainability & Climate Trends to Watch 2024
3 – PWC, Managing nature risks: From understanding to action, April 2023

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Benefits of a just transition and higher morale

Last year we saw a host of strikes and other collective worker action around the globe to improve pay and work conditions. This included strikes at a global oil major that rattled gas prices. We are likely to see more of this ahead with an ongoing push for greater labour power and a 'just transition'.

Discussions at Cop 28 and PRI in Person included much emphasis on the importance of social dimensions of sustainability, with a focus on achieving a just transition that doesn't disadvantage certain geographies or segments of society.

To this point, the past few decades have seen a significant portion of carbon-intensive industrial activities being relocated from developed countries to emerging economies due to lower production costs and less severe scrutiny over environmental issues. Emerging markets in Asia, such as China and India, have taken up a majority of such activities. Clearly, efforts by Asian governments and regulators will be vital to both decarbonisation and achieving a just transition ahead.

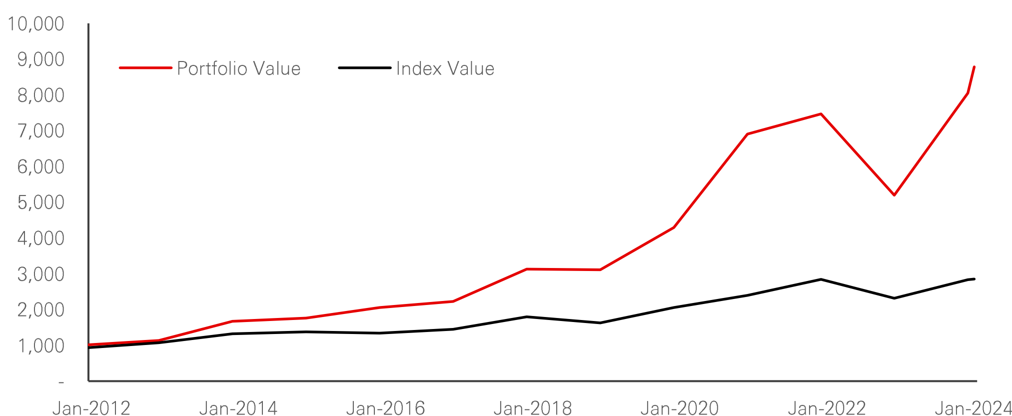
Our survey respondents share this sentiment, with the largest share of respondents indicating that to support a just transition, governments and public agencies in Asia should prioritise resource allocation over the next 3-5 years to facilitate early and responsible closure of carbon-intensive assets.

Such structural shifts from the net zero transition will impact the people and communities in these developing economies, such as workers facing redundancies. A human-centric approach will ensure that neither developing countries, nor workers in carbon-intensive industries in developed countries, will bear a disproportionate burden in the transformation to a low carbon economy. This entails communities reliant on heavy carbon emitting sectors being supported in pivoting their industries to adapt to a lower-carbon environment while training their workforce. The $100 billion per year committed to developing countries in climate finance in prior Cop summits can support this.

Greater emphasis on inclusive growth will likely be part of discussion between companies and investors going forward. Again, this has important financial implications for investors. Social unrest related to shifting industries and job opportunities poses risks to political structures and economic growth. Furthermore, a prominent study of stock market returns from 1984 to 2009 demonstrated materially better performance by companies with higher employee morale.[4]

> The $100 billion per year committed to developing countries in climate finance can support the 'just transition'.

Figure 4: Performance of each year's top 25 companies to work for versus global equities



Source: HSBC Asset Management, Bloomberg, Great Place To Work Institute, February 2024.

4 – Alex Edmans, Does the stock market fully value intangibles? Employee satisfaction and equity prices, Journal of Financial Economics, 2011

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The chart on the previous page (figure 4) demonstrates this phenomenon continuing, with a portfolio comprised of each year's top 25 companies to work for (as ranked by the Great Place To Work Institute) outperforming global equities. Of course, such a concentrated portfolio creates inherent biases, but nonetheless serves as interesting support for the argument that companies with higher employee morale and a more positive impact on the communities in which they operate, can achieve better productivity and outcomes.

At a broader level, MSCI research demonstrates that top quintile 'S' score equities outperformed their bottom quintile peers over the last decade, with outperformance more significant than equivalent comparisons for 'E' or 'G' scores.

This only reinforces the point that investors should not overlook the importance of company contributions to social progress. When it comes to societal considerations, any discussion today would be incomplete without mention of developments in artificial intelligence. Rapid progress in the technology has contributed to much angst around societal risks, from data privacy to widescale elimination of human jobs. Related discussions between regulators, industry leaders and academics have picked up steam.

The EU appears to be furthest ahead in formally addressing concerns, with a proposed AI Act outlining a comprehensive governance framework around AI systems, extending from product development to data privacy.

Importantly, while AI will certainly improve automation and reduce the need for certain human tasks, it will also enhance human productivity. Companies that apply inclusive growth principles will prioritise training workforces with the relevant skills to work alongside new AI capabilities and increase output. We expect that upskilling will become even more vital to addressing workforce needs as the technology landscape shifts.

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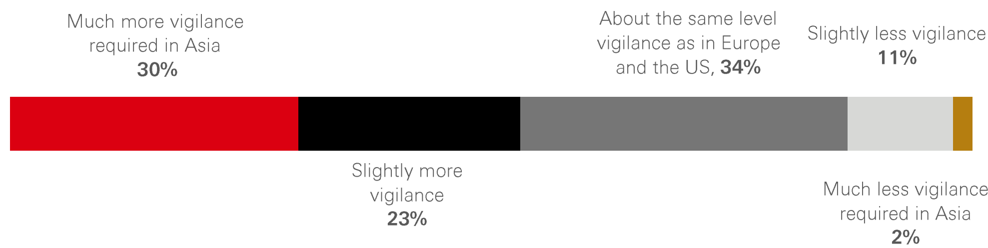
More transparency needed

We are seeing real change in terms of data availability, reporting outcomes, and increasing scrutiny on various types of ESG activities – both from companies as well as asset managers and pension funds – due to the establishment of various disclosure frameworks globally. Greater scrutiny will mitigate the risk of greenwashing which, according to more than half of our survey respondents, requires more vigilance while considering sustainable investments, especially in Asia relative to Europe and the US.

Companies in Asia that are aligned with the EU taxonomy have expanded their sector relative price premiums to 55% versus earnings.

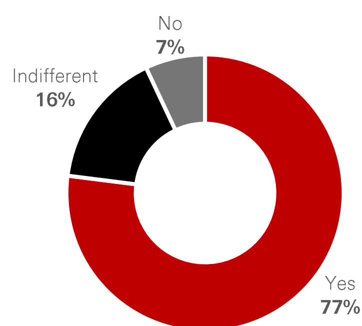
Figure 5: Vigilance required to avoid greenwashing risk in Asia compared to Europe and the US



Source: HSBC Asset Management, October 2023. Survey of PRI in Person 2023 attendees[5].

The International Organization of Securities Commissions (IOSCO) has supported the rapid development of global disclosure standards in the last several years, which has mirrored the shift of societal and market opinions. However, without still greater convergence, consistency, and interoperability between policies across jurisdictions, particularly for disclosure frameworks and standards such as ISSB and SFDR, many companies will continue to face the challenge of different reporting systems. This was further underlined by our survey results, where over three-quarters of respondents support the gradual convergence of sustainable investment related regulations in Asia with European standards.

Figure 6: Support for gradual alignment of sustainable investment regulations in Asia towards European standards



Source: HSBC Asset Management, October 2023. Survey of PRI in Person 2023 attendees[5].

Of note, companies in Asia that are aligned with the EU taxonomy have expanded their sector relative price premiums to 55% versus earnings, surpassing the global average of 37%. Such outcomes support the argument for corporates to target the highest levels of reporting transparency, and investors to seek those businesses delivering it.

5 – Over the course of the PRI in Person conference, we engaged with 56 attendees including investment managers and asset owners, and inquired into their views on sustainable transition and investment in Asia through a survey.

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The ISSB recently announced the implementation and consistent application of IFRS S1 - 'General Requirements for Disclosure of Sustainability-related Financial Information' and IFRS S2 - 'Climate-related Disclosures'. These sets of standards will be an important step towards a global baseline of sustainability-related disclosures and will improve transparency, accountability and efficiency in financial markets.

Another important initiative that was launched following PRI in Person 2023, was the final Transition Plan Taskforce disclosure framework. This framework includes elements of the just transition - to take a human-centric approach while helping developing countries transition to a low-carbon economy, while setting new standards for how companies set out a transition plan. It will be incorporated as part of the ISSB by 2025. Regulators have also shown support for the ISSB framework, and the European Commission has announced its integration into their Corporate Sustainability Reporting Directive (CSRD) framework.

This progress in the development of sustainability standards and guidelines, which supports consistent application across the globe, lays the groundwork for investors to more rigorously apply sustainability considerations across investment universes in future.

Greater reporting consistency globally will be positive for holding companies accountable for their impacts wherever they operate.

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Remaining challenges

A key challenge that most acknowledge is that the Sustainable Development Goals (SDGs) are not being achieved and the Earth's average temperature is rising, with alarming consequences. In terms of addressing these shortcomings, a challenge for the asset management industry is that we still measure SDGs largely by revenue alignment rather than by outcomes. This has fuelled a call to action to consider how we can systematically measure our impact in real-world outcomes.

Recent discussion has also focused on the ESG backlash from some segments. While some debate can distract from the real issues, it has raised some important questions. The positive outcome has been greater awareness of ESG investing as an option for individuals to align their investing choices with their values. Bringing these choices more clearly to the end investor means that the use of language and choice of words has become increasingly important.

Policy development on ESG issues has grown exponentially to address questions raised, such as the EU's Sustainable Finance Disclosure Regulation and the ISSB frameworks mandating disclosure of Scope 1, 2 and 3 greenhouse gas emissions as part of accounting metrics to avoid greenwashing practices. Furthermore, issues beyond emissions are now gaining visibility, like biodiversity, natural resource management and the focus on a just transition to include human rights and labour practices while pursuing a sustainable transition.

Even amidst ongoing challenges, there have been tangible initiatives implemented and progress made in many areas. In the US for example, the 2022 Inflation Reduction Act issued by the Biden administration has driven change, with $369 billion earmarked for addressing climate change and green energy investment over the next 10 years. The act provides significant tax incentives for renewable energy projects and simultaneously encourages companies to onshore the clean energy value chain, fostering re-industrialisation and quality job creation. The act has already resulted in the announcement of over 280 clean energy projects representing around $300 billion of investment.

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Looking forward

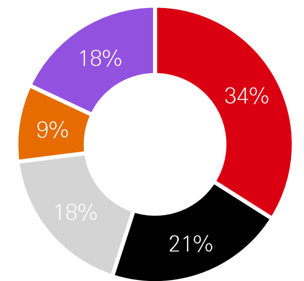
Asset managers need to recognise and address systemic issues like climate change, biodiversity loss, and social inequality that are often exploited, mismanaged or unaccounted for by businesses. These issues can potentially destroy value across an economy and a diversified investment portfolio. Fortunately, improving availability of data and more consistency in regulatory standards is enabling us to incorporate these considerations into the investment decision-making process globally.

We believe that ESG stewardship considerations and investment performance are linked and aligned. While many asset owners and managers have already started incorporating systemic issues in investing and stewardship activities, no one asset manager can drive systemic change individually. Collective action to deliver corporate transparency across jurisdictions will support tangible results and more sustainable business models, to the benefit of investors.

This does not come without challenges, such as potential conflicts of interest. The incentive structure for asset managers to address risks posed by systemic issues and track impact on investment performance is important. Thus, an open dialogue is needed throughout the investment chain to identify and manage any expectation gaps.

We also believe that the scale of challenge posed by climate change is clearly immense. Investing in innovative technologies and approaches with an aim to accelerate decarbonisation and achieve broader sustainability goals will help reduce climate risks in portfolios, and will incorporate investment opportunities that are emerging as part of the transition to net zero.

Figure 7: Steps an investment manager may need to implement to build a robust SI capability in Asia



- Integrate ESG factors into remuneration of investment professionals
- Enhance internal and external communication on SI related topics
- Improve governance structures and policies to avoid greenwashing
- Increase headcounts and new hires with expertise related to SI
- Invest in improving ESG data quality

Source: HSBC Asset Management, October 2023. Survey of PRI in Person 2023 attendees.

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