Sustainability Insights

Sustainable investing: the basics

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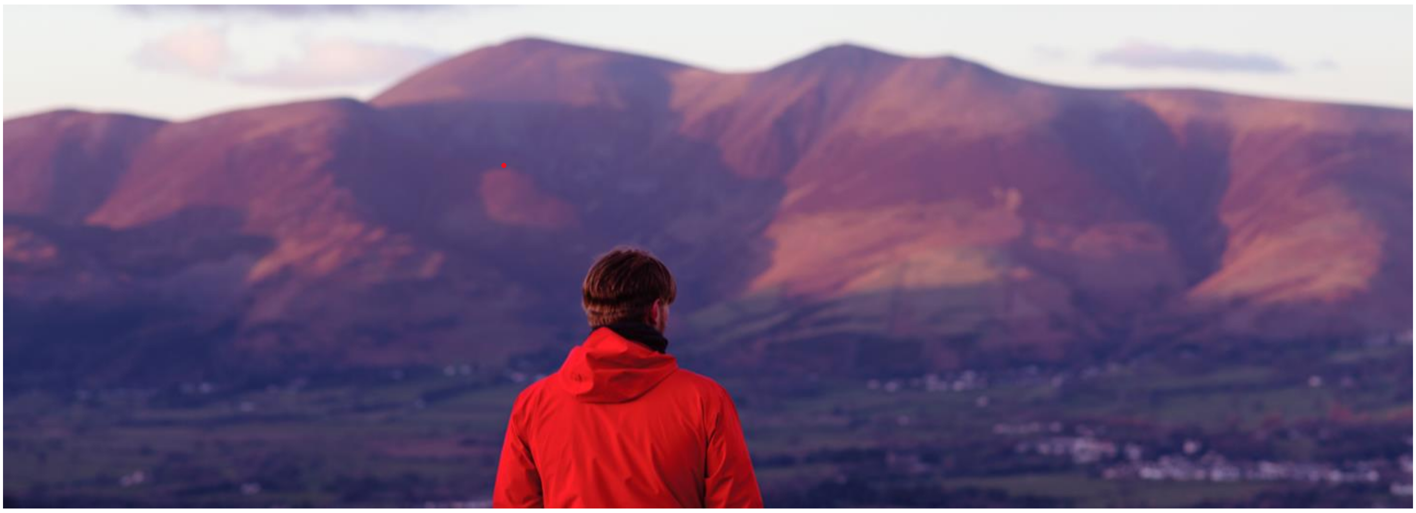

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Sustainable investing is a broad topic, with many different approaches, objectives and lingo. But what is right for me and how should I set my investment strategy? To help you, we have developed 6 basic principles. They're not exhaustive, but we believe they're a good place to start.

1. **Know what you want to achieve**: because 'why' you want to invest sustainably will guide the 'how'. Some investors are values-driven, which may lead you to exclude certain sectors and activities, while others will look at sustainability to discover new opportunities and risks and generate better risk-adjusted returns, or make a direct impact.

2. **Adopt a medium to long term approach:** because the net zero transition needs long term capital, corporate engagement takes time to yield results, and some new technologies will take time to become profitable. In our view, the short-term performance of investments is principally linked to financial factors, not sustainability factors.

3. **Consider sustainability across all asset classes:** because all asset classes need to contribute to the funding of the climate transition and are affected by the changing investment environment. Diversification also helps broaden the opportunity set.

4. **Incorporate sustainability in both the core portfolio and satellites**: because thematic investments can be directly linked to your area of interest, but all companies in the core portfolio are affected by sustainability, and they will influence your portfolio's overall ESG score.

5. **Make sure your investments do what it says on the tin (avoid greenwashing)**: as definitions and practices are still evolving, the role of a strong fund selector or advisor is key to ensure the investment matches the strategy and objectives you have set.

6. **Evolve with the market**: because a growing, more transparent and competitive market will provide more opportunity and liquidity to investors. With time, we see no reason why investors would not incorporate a sustainability approach across the entirety of their portfolio.

1. Know what you want to achieve

Before developing an investment strategy and deciding what to invest in, we believe investors first need to decide why they want to invest sustainably, because the 'why' will influence the 'how'. We know that our clients are looking to make an impact on social and climate measures, with 80% of them thinking ESG factors are very important to take into account. But every client is different.

a. **Your values: exclusion vs engagement and best-in-class vs ESG momentum**. Some investors will choose to invest sustainably because of personal or societal ethical values, or because of their religion, which often leads to the exclusion of certain business activities from their portfolios (most often arms, alcohol, tobacco). Increasingly, some investors also feel that continuing to fund energy and mining companies is against their personal or family values.

   For others, the argument is more nuanced. Instead of excluding companies in certain (sub-)sectors from the portfolio, they prefer to make a positive change by engaging with them, through shareholder proposals at general meetings and relying on investor alliances, in order to promote better corporate behaviour. Such investors typically don't look for the companies that already have the best ESG scores (best in class), but are happy to invest in companies which show good improvement (positive ESG momentum). They will argue that companies that are on a transition to make their activities more sustainable still need funding, and engagement together with funding through green bonds, for example, can help speed along the process. Investing in companies that are committed to making the transition may still be aligned with the investor's family values.

   Finally, there are other investors who will point out that excluding sectors or activities from the portfolio reduces the opportunity set, and those investors may instead choose to take a different approach (e.g. thematic – see below) or promote their values through philanthropic activities.

   It is clear that there is no 'right' or 'wrong' approach on the topic of these family values, but where you and the next generation stand on this topic will help you and your advisor to determine the appropriate investment strategy. From our perspective, **we think there is a lot to say in favour of helping companies transition**, by funding or investing in companies may well have higher emissions but the potential to contribute significantly to reduce emissions.

b. **Risk management and alpha vs impact**. Regardless of how you look at the values question, you may view the sustainability revolution as sufficiently material to want to explore the related investment risks and opportunities. We certainly do. Most investors now have come to realise that they need to have a good understanding of a company's Environmental, Social and Governance dynamics in addition to traditional financial ratios to truly understand a company's future earnings path and risks, and therefore its fair value. If managing risks (physical risks, transition risks, reputational risks etc) and discovering opportunities are your main objectives, then an ESG enhanced approach complemented by thematic investments may make most sense. We believe that **companies that think ahead and adapt their business model to the sustainability revolution and make it future proof will have a better long-term risk/return profile**.

   But some investors will want to have a more direct impact on social or environmental causes and even be willing to give up some returns or alpha as long as they know they are contributing to a specific and measurable cause. For them, impact investing may be the way to go.

ESG Enhanced
Invest in companies based on relative ESG performance

Thematic
Focus on themes and sectors dedicated to resolving climate and sustainability challenges

Impact
Focus on a direct, positive and measurable impact on society and/or the environment

c. **Which SDGs or measures do you care about most?** 'Sustainability' is a broad term which includes many different possible objectives. The UN Sustainable Development Goals are a handy place to start, and the 17 SDGs are now used by asset managers and advisors to match products to what their clients care about most. In that way, you can check what percentage of your portfolio is linked to the SDGs that you have prioritised. We note that some SDGs are more easily investable in public markets (e.g. affordable and clean energy, clean water and sanitation) while others (no poverty, zero hunger, quality education) may sometimes need investment through private markets or through an impact approach.

   There are many other ways to look at it, though. In terms of climate change, some investors want to focus on mitigation strategies (helping limit climate change) while others want to focus on adaptation strategies. A recent investor survey by our HSBC Global Research colleagues showed that among environmental issues, decarbonisation and climate mitigation are the principal concern (45%), followed by climate resilience (adaptation, at 20%), with plastics (6%) and biodiversity (2%) some way behind. One specific measure for those focused on mitigation is 'portfolio temperature', where the objective is to pick investments that together contribute significantly less to global warming than the market benchmark. Others will want to know the weighted carbon intensity of their portfolio. Tracking and minimising violations against the UN Global Compact is another way to go, and some investors who do not want to prioritise one goal over another will simply want to achieve a high average ESG score on their portfolio. Again, there is no right answer here, in our mind, but **a clear view on what you care about most and want to achieve** will be very helpful when developing your investment strategy and composing your portfolio with your advisor.

2. Adopt a medium to long term approach

When family values and those of the **next generation** are driving your sustainability investments, it is clear that a long term approach is needed. It is also clear that the energy transition is a long term project. At best, the **path to net zero will take till 2050 or 2060** in most countries, and require an estimated USD 3.5trn investment in the energy sector each year, for example. And the war in Ukraine made energy independence a strategic goal, which will further raise the investment in sustainable energy sources (as well as fossil fuels), for decades to come.

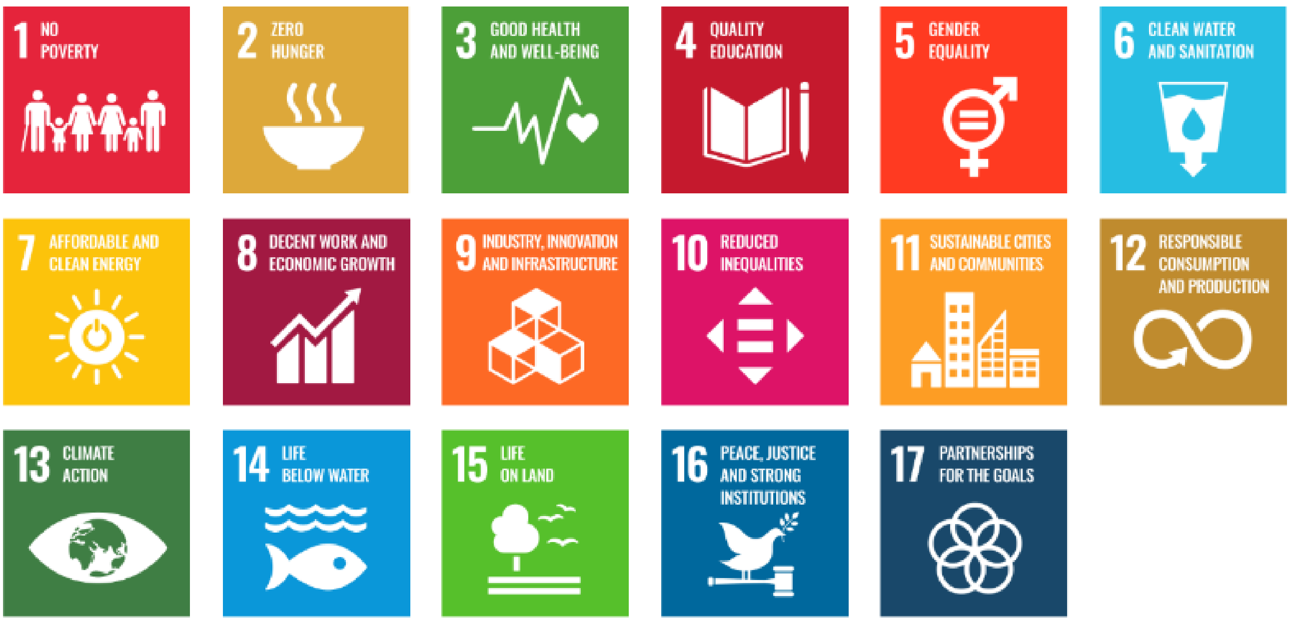
Not all investments are immediately profitable, of course, and **companies will need to convince investors to provide long term funding**. Funding for the long term is often quite natural in private markets, and it is no coincidence that private companies often invest up to 6 times more capital than listed ones. Public markets have in fact become very short-term in nature, with information affecting the stock price in micro-seconds and the pressure of quarterly results and management incentive schemes linked to those objectives creating a bias towards the shorter term. Investors who care about fair goals and strong governance are probably well placed to recognise the bad incentives of short-termism, and may be willing to commit for the longer term as long as the company can convince them of their longer term vision, commitment, and execution.

We also believe that a company's sustainability transition will work better if it has more real 'owners' among their shareholders, which do not divest on each negative short-term headline, but instead engage with them to effect the change they want to see. And that **engagement requires a medium to long term approach**: a recent survey by our HSBC Global Research colleagues showed that respondents believe engagement is most effective over a 3-to-10 year horizon.

Some of the technological solutions that will help us reach the net-zero point already exist, but many other **technologies still need to be refined or still be invented**. Bill Gates likes to say that we tend to overestimate the change in the next 2 years, but underestimate the change in the next 10. That again points to the need for a long term approach.

And finally, to state the obvious. We're often asked why ESG indices or sustainability-related investment themes have behaved in a certain way in the past month or week. Much of what moves the stocks and bonds of companies with strong sustainability credentials will be the same financial factors that move those of companies with poor sustainability credentials. There is no reason to expect sustainability credentials to make your stock or bond react differently to a Fed meeting or a surprise in the latest inflation data. They are sensitive to the same financial factors. For example, innovative companies in the energy transition space will trade like growth companies, and sell off in the short term when interest rates rise. Companies with high ESG credentials will often have some of the characteristics of quality style stocks, and therefore underperform when risk appetite is high (and vice versa). It's important to realise that a **short-term set-back in performance will mainly be linked to financial factors**, and is not a reflection of the longer term sustainability strategy of the company.

To choose or not to choose – the UN Sustainable Development Goals (SDGs)



Source: United Nations as at 29 April 2022.

3. Consider sustainability across all asset classes

The huge global investments needed to halt climate change cannot be financed in niche markets. For most renewable energy projects, the upfront investment is very high, with relatively low ongoing costs compared to fossil fuel projects. So, a lot of financing is needed. So far, many of these projects have been funded through utilities' balance sheets, via bank loans, but the **source of funding will need to broaden**. Bond market financing has been growing rapidly, in part because of the green bond principles which set standards and create investor trust. There are now green bonds, sustainability bonds, social bonds, blue bonds and transition bonds in most geographies and sectors, allowing bond investors to build bond portfolios with any duration and rating quality they want, but better sustainability credentials.

But given the vast need for funding, funding in public stock markets and private equity and debt markets will be important too. ESG ETFs have displayed rapid growth in recent years and are forecast to reach $1.5 trillion in assets under management globally by 2025, according to SSGA. Equities were first to dazzle, but bond ETFs have been showing very rapid growth recently. Indeed, ESG fixed income ETF assets grew by a lofty 44% in the past 12 months according to Bloomberg figures. Actively managed funds are proliferating rapidly too. That means **more choice, more liquidity, and more sway** by the managers, who will have more influence through corporate engagement.

Broadening the net across a wide range of traditional and new asset classes allows for **increased diversification**. Carbon credits and natural capital are still relatively new but seem to be driven by different fundamental factors than many other assets, and should therefore help diversification. Private equity (for suitable and sophisticated investors) fits well with our view that sustainable investing should take a long term approach, as we have discussed before. Private equity managers can effect significant change when they become a major shareholder, and this means they can implement more energy efficiency projects, for example and bring sustainability to the core of a company's strategy. Opportunities in natural capital and climate venture technology will often fall in the private markets space. By comparison, Hedge Funds' typically shorter investment horizon may be a less natural fit but some still use sustainability factors as part of seeking returns (and also use exclusion). Many have appointed a compliance officer, while the 2017 PRI survey for hedge funds can also be used to assess ESG practices. As for commodities, the debate will continue to rage whether the increased prices that can occasionally come from commodity investments outweigh the benefits of more liquidity and a better functioning market.

Climate risk is not something that we can diversify away, as it **cuts across every asset class**, and hence needs to be considered everywhere. Moreover, investors who build sustainable portfolios but leave out certain asset classes will not be fully diversified and risk building portfolios that are sub-optimal in the longer term.

4. Incorporate sustainability in both the core portfolio and satellites

Thematic investments are most often positioned as satellites around a well-diversified core portfolio. They typically consist of companies that offer **specific product solutions or services** that will enable us to make the transition to a more sustainable world (e.g. climate change mitigation or adaptation solutions, or specific impact investments related to any of the SDGs). Our high conviction themes related to sustainability are popular, but we think sustainability should not end there.

Any company in **the core portfolio will also be affected** in several ways by the sustainability revolution, such as technological change, increased constraints imposed by nature, regulatory and policy changes, and the rise of multi-stakeholder capitalism. For companies, it's about building future-proof business models. And for investors, it's about integrating a wider array of issues through ESG analysis, to be **better aware of risks and opportunities in the core portfolio** than investors who don't integrate them.

Most often, thematic investors look for companies for whom sustainable solutions form the bulk of their activities, to ensure that they have a material impact on the stock price. One of the potential concerns with this is that such **'pure plays' can be relatively rare and therefore expensive.** Indeed, innovative and young companies can either still have a small market cap or may still be held in private hands (not yet floated). By broadening the net and looking for more established companies with some part of their business involved in sustainable solutions, investors can still increase their exposure to sustainability-related themes. If this is done consistently throughout the core portfolio, the overall exposure to sustainability may quickly add up, and it may be at lower valuation multiples than in the thematic satellites.

Finally, we note that many of the thematic investments related to sustainability developments will have a **sector bias** (utilities, technology) and/or a **style bias** (growth stocks). Portfolios that express all of their sustainability goals through thematics may therefore be less diversified than portfolios that spread their sustainability goals over both the thematics and the multi-asset core portfolio holdings.

5. Make sure your investments do what it says on the tin (avoid greenwashing)

In a recent survey by our Global Research colleagues, 33% of institutional investors said that the strongest reason for incorporating ESG in their process was to attract capital, while another 26% principally do it because of competition and peer pressure. With fund assets likely to grow 3 times as fast for ESG funds compared to non-ESG funds by 2025, this is no surprise. And of course there is nothing wrong with trying to attract funds by adapting to demand, as long as it is done properly.

But doing it properly can often be as much an art as a science, as the market is still evolving, standards are not uniform, definitions are blurred and open to interpretation or judgment. Along with the profusion of fund choices, concerns about "greenwashing" have grown. The concerns are exacerbated by the fact that ESG funds are far from homogenous – i.e. fund portfolios could look very different from each other. Before reaching any conclusions it is **important that investors understand the funds that they buy and appreciate the reasons for variations**.

- First, there is **no one common definition of ESG**, even among ESG rating agencies. Berg et al of MIT-Sloan pointed out in their Aug 2019 paper, that correlations between the scores of six major ESG rating providers were low, varying between 0.38 to 0.71. A company that scores highly on one ESG rating agency's scale could be a low-ranked ESG company on another. By way of comparison, credit ratings would have correlations well above 0.90.
- Second, **asset managers may design portfolios differently**, even where the funds have similar names. Take the example of climate change: one fund manager designing a climate change fund may focus on companies adapting to climate change (and avoiding financial losses from climate change risks), while another fund manager may focus on companies which are in the business of providing green energy, or are developing technologies that can help mitigate climate change. Clearly, these two approaches would result in portfolios that look very different, though the funds may have the same name.
- Third, the portfolio construction method may mean that some funds hold **securities from issuers which clients do not expect to see** in an ESG fund. As an example, an ESG fund may hold securities issued by a fossil fuel company. This could be for various reasons. The manager may be aiming to improve the portfolio ESG score, but within a tracking error range to the benchmark, and may wish to not exclude sectors in their entirety. In the case of fixed income funds, the fund may hold green bonds issued by companies in polluting sectors - as it is the use of proceeds, rather than the issuer sector which leads to the "green" classification. Finally, it is possible that the manager believes that staying invested with the fossil fuel company, and engaging with management to drive change, is a better approach than divesting. In this context, it is worth pointing out that divesting the stock in the secondary market would simply mean a change of ownership. It would not affect CO2 emissions, nor would it immediately impact the actual capital available to the company.

All of the above mean that ESG funds can vary quite significantly from each other. It is **critical that investors do not simply go by the ESG fund name or label**, but take the time to properly understand the fund they are investing into and ensure that it aligns with their objectives. As a simple example, investors who wish to specifically exclude certain companies or sectors would need to ensure these exclusions are hard-coded into the fund's mandate.

In summary, when selecting funds, we believe it is important to follow a diligent approach, focus on thoroughly understanding the fund managers' approach and intent and follow that up by analysing the resultant portfolio to ensure consistency with the approach that has been articulated.

6. Evolve with the market

Sustainable investing has been evolving rapidly over the years, shaped by events (oil spills, energy dependence on Russia), regulation, changing knowledge (climate change, health issues), perceptions, focus and real world policies.

We think investors should adapt with it. The good news is that, as the market grows, it will become more standardised and competitive, giving investors more choice and making it more efficient. As risks and opportunities are more clearly identified, they should be more adequately priced. And as more asset classes and themes become investable, we see no reason why investors would not incorporate a sustainability approach across the entirety of their portfolio.

Disclosure concerning sustainable investments

"Sustainable investments" include investment approaches or instruments which consider environmental, social, governance and/or other sustainability factors (collectively, "sustainability") to varying degrees. Certain instruments we include within this category may be in the process of changing to deliver sustainability outcomes.

There is no guarantee that sustainable investments will produce returns similar to those which don't consider these factors. Sustainable investments may diverge from traditional market benchmarks.

In addition, there is no standard definition of, or measurement criteria for sustainable investments, or the impact of sustainable investments ("sustainability impact"). Sustainable investment and sustainability impact measurement criteria are (a) highly subjective and (b) may vary significantly across and within sectors.

HSBC may rely on measurement criteria devised and/or reported by third party providers or issuers. HSBC does not always conduct its own specific due diligence in relation to measurement criteria. There is no guarantee: (a) that the nature of the sustainability impact or measurement criteria of an investment will be aligned with any particular investor's sustainability goals; or (b) that the stated level or target level of sustainability impact will be achieved.

Sustainable investing is an evolving area and new regulations may come into effect which may affect how an investment is categorised or labelled. An investment which is considered to fulfil sustainable criteria today may not meet those criteria at some point in the future.

Greenwashing risk is defined as giving a false impression or misleading information of a product's climate and environmental friendly credentials and, whilst not considered a standalone risk, can manifest through sales outcomes, marketing materials, product design and external disclosures at product and firm level.

Risk Disclosures

Risks of investment in fixed income
There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk
Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments
High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
- Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
- Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures
- Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
- Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or canceled. Investors may face uncertainties over when and how much they can receive such payments.
- Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non-viability. These features can introduce notable risks to investors who may lose all their invested principal.

Changes in legislation and/or regulation
Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalisation risk
The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalization.

Reinvestment risk
A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate. Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may significantly affect the prices and mark-to-market valuation.

Risk disclosure on Dim Sum Bonds
Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government.
Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond.
There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk.
Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks.

Investors should be prepared that you may need to hold a renminbi bond until maturity.

Risk disclosure on Emerging Markets
Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalization or expropriation of assets;
(b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate;
(c) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

Risk disclosure on FX Margin
The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer. Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

Currency risk – where product relates to other currencies
When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

Chinese Yuan ("CNY") risks
There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.

There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

Illiquid markets/products
In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

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