Sustainability Insights

CIO Office

This Earth Day, let's reset the human-nature relationship: from exploitation to symbiosis

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- **Since the advent of modern capitalism, humanity has predominantly viewed nature as a mere extractive system meant to serve its needs, while externalising the costs back to nature**. As a result, our ecological and climate systems are on the verge of a breakdown. With each passing day, there's a pressing need to foster greater harmony between humanity and nature, to preserve and regenerate our ecological ecosystems.
- **Why? Because our life, societies, livelihoods and economies depend on nature** for the natural regulation of global cycles (weather patterns) and provision of basic materials like food and wood. These basic resources and essential ecosystems are worth between $125-$140 trillion annually[1]. However, as ecosystem services are not assigned a nominal value, we tend to underestimate our dependencies on nature and the impact of their loss on our financial and personal wellbeing. With nearly 50% of the global GDP (circa $44 Trillion) underpinned by nature[2], the rapid loss of biodiversity poses a systemic risk to global economic activity.
- **This Earth Day, we try to reimagine our relationship with nature – to move from extraction to mutualism** – and aim to create a world where human activities regenerate rather than net exploit ecological systems[3]. This calls for a shift from the linear 'Make – Take – Use - Waste' economic model which is damaging biodiversity and natural habitats at an unprecedented scale, to a circular economic model of 'Reduce – Repair – Reuse – Recycle and Re-design' (5Rs).
- **We think that the concept of 'circularity' signifies a regenerative symbiosis between humans and nature**. It re-establishes the relationship humans have had with nature thus far, moving beyond extraction to foster a reciprocal co-evolution, and creates a new dynamic where human activities enhance and regenerate, rather than just exploit the natural ecosystems [3]. Circular economy is also at the heart of the Net Zero Transition as the concept of 'circularity' focuses on sustainable development of products and systems, like incorporating recycling to minimise waste and conserving natural resources.
- **We believe circular economy could become a meaningful differentiator between winners and losers in a range of sectors over the medium-to-long term**. Some sustainable production and long-use/reuse business models adopting the '5Rs' are not only able to preserve the planet's biodiversity and help reduce CO_2 emissions, they also benefit from lower costs (through use of recycled of materials), and have the potential to turn sustainability into a business moat and a strong profit driver, especially as planet conscious customers are willing to pay more for their high-quality sustainable products.

"Humanity has become a weapon of mass extinction" –

Was the opening remark from UN Secretary-General António Guterres to the delegates attending the United Nations Biodiversity Conference in 2022. But while it might sound alarming, this statement doesn't seem to be an exaggeration when one looks at the scale of species facing extinction.

According to a UN Global Land Outlook assessment, **more than 1 million species are now threatened with extinction, vanishing at a rate not seen in 10 million years**. As much as 40% of earth's land surfaces are considered degraded. Human activity for food production, infrastructure, energy and mining accounts for 79% of the impact on threatened species [4].

But earth's biodiversity is crucial for our existence and for our financial well-being. The diverse life on this planet is the main source of supply of our basic essentials – the air that we breathe, food, water, several sources of energy, medicines, building material and human well-being. From crop pollination to removal of carbon from the atmosphere (carbon sequestration), the services that nature provides us with are worth an estimated $125-140 trillion annually, which roughly equates to ~1.5 times global economic output per annum[1].

But as these natural ecosystem services are not assigned a nominal value in the formal economy, we fail to recognise their true value and contribution to our economic output. By doing so, **we over-look the 'materiality' of 'nature risks'** and the potential loss of economic value if biodiversity loss persists, and the nature's balance goes out of whack.

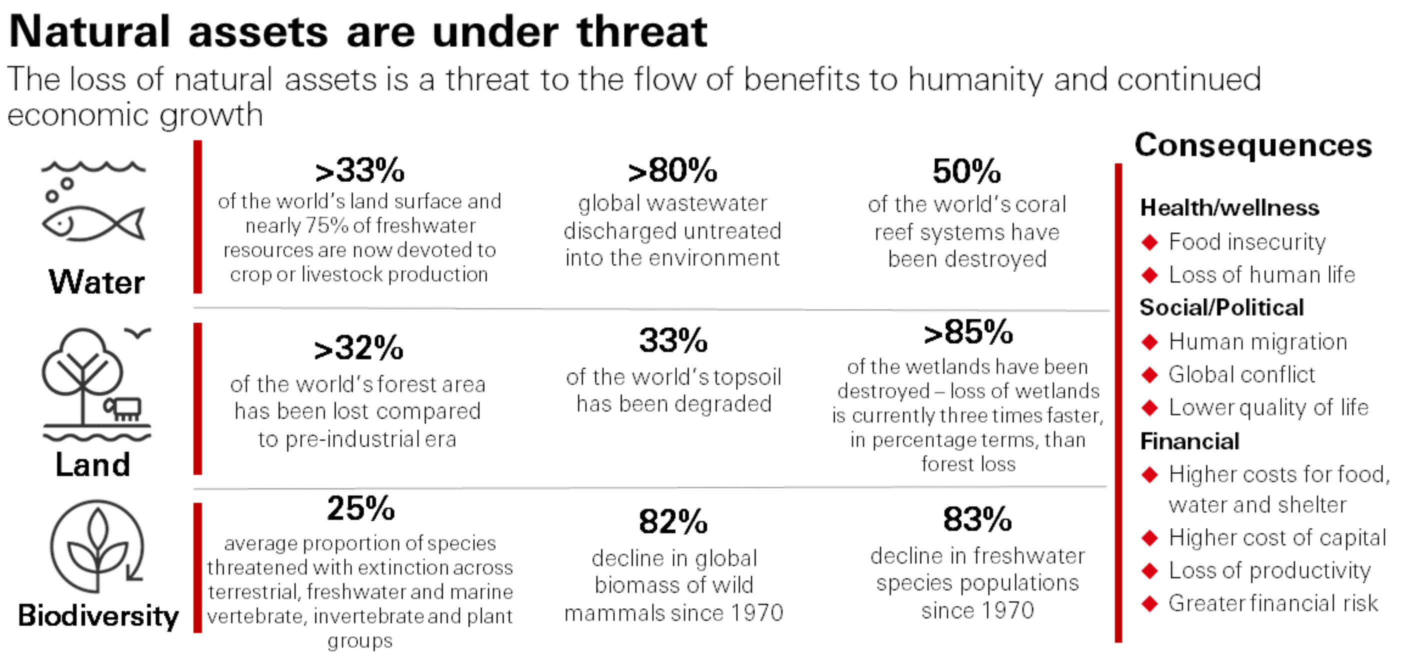
However, we assign nominal value to businesses, which are all heavily reliant on nature and its services. But business activities contribute to the drivers of biodiversity loss: Climate change, pollution, overexploitation of natural resources and changes in land use/sea use. It's noteworthy that by continuously destroying nature, we are creating a risk of wiping out $44 trillion of economic value generation – over half the world's total GDP [4].

Unsurprisingly, biodiversity loss was ranked as the third most severe threat humanity will face in the next 10 years in the World Economic Forum's Global Risks Report 2022. And while the world of business and finance is paying great attention to climate change, the issue of biodiversity has largely gone unnoticed until recently.

Therefore, this Earth Day, the 22 April 2024, we try to re-imagine our relationship with nature – to move from extraction to mutualism – and create a world where human activities regenerate rather than net exploit ecological systems [3].

To halt the loss of biodiversity and to reverse it, we need to create a '**nature positive economy**'. This calls for a shift from the linear 'Make – Take – Use - Waste' economic model which is damaging biodiversity and natural habitats at an unprecedented scale, to a sustainable circular economy model. To create a 'nature-positive' economy, a fundamental transformation across three socio economic systems which represent over a third of the global economy and provide up to two-thirds of all jobs, is required. According to the World Economic Forum's Future of Nature and Business Report, July 2022 - a critical shift towards nature positive models in the following three socio-economic systems is needed:

- **Food, land and ocean use**: Efforts like ecosystem restoration and avoided urban expansion; the adoption of productive and regenerative farming; maintaining healthy and productive oceans; sustainable management of forests; and sticking to planet

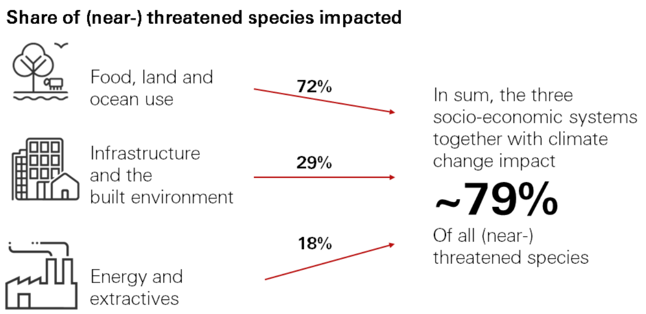


Source: Food and Agriculture Organization of the United Nations, HSBC Global Private Banking, April 2024 compatible consumption are needed to prevent loss of biodiversity and to restore it.

- **Infrastructure and the built environment**: Diversification of the urban environment; adopting nature positive built environment design by accommodating nature and natural ecosystems in new urban developments; developing planet compatible urban utilities like green energy; using nature as infrastructure for e.g., harnessing wind and solar energy help nature co-exist and thrive in urban environments.
- **Energy and extractives**: Use of circular and resource efficient models, nature positive minerals and metals extraction; sustainable materials supply chains; and nature positive energy transition solution are needed.

These systems not only have a significant opportunity and responsibility to reverse the loss of nature, but they also have tremendous upside benefits to gain by embracing this transformation now [4].

Three socio-economic systems endanger around 80% of threatened or near-threatened species

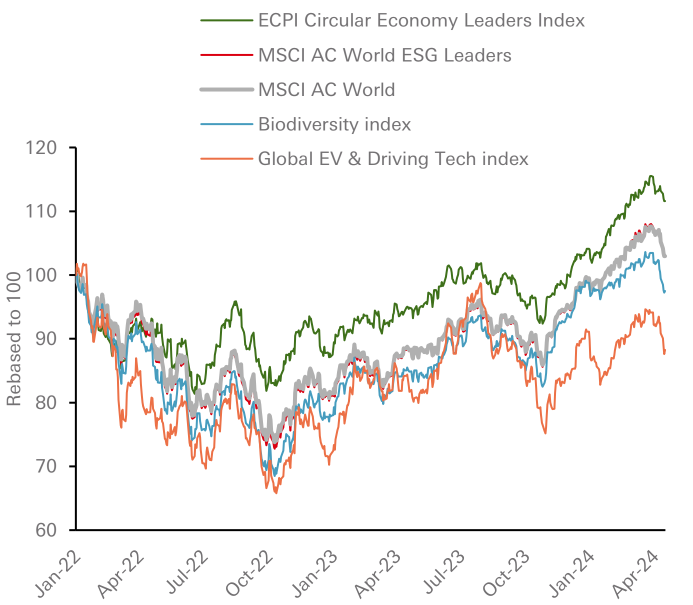


Source: World Economic Forum, HSBC Global Private Banking, April 2024. Due to partial overlap between the species impacted by the three systems, the percentage of species impacted by all systems is smaller than the sum of percentages of the species impacted by each system.

Alongside these socio-economic transitions, the business world too needs to switch from the 'Linear' to a 'Circular economic model', to minimise the waste of natural resources and preserve the natural ecosystems.

The 'Take – Make – Use - Waste' Linear approach to production and consumption is not just unsustainable, but also uneconomical – for producers, consumers and for our environment. It amounts to billions of dollars of economic value wasted in the form of raw materials, manufacturing costs and the cost of waste disposal.

Circular economy index has performed better than the EV sector and should overtime become a meaningful differentiator between winners and losers in a range of sectors



Source: Bloomberg, HSBC Global Private Banking, April 2024. Past performance is not a reliable indicator of future performance.

In stark contrast to the conventional Linear approach, **Circular economy presents a nature friendly alternative** which aims to separate economic growth from the consumption of finite resources. It maximises utilisation of underutilised economic assets by increasing the use of these assets through sharing, renting and on-demand service offerings and by doing so creates new sources of revenue. Key raw materials are fed back into the economy, making better use of natural resources, whilst saving businesses on their costs.

Businesses can replace their legacy linear economy products and systems with circular economy ones by adopting the **5Rs model of Reduce – Repair – Reuse – Recycle – and Re-design**:

- **Reduce**: The use of raw materials by using high quality materials to produce durable products that last longer.
- **Repair**: Offer free repairs or fixes for product reuse.
- **Reuse**: Companies also offer to take back their used/ pre-loved products, repair them if needed and then offer them at a discounted price to someone else.
- **Recycle**: They take back their preloved products to reuse some or all the components or recycle the raw materials to manufacture new products.
- **Re-design**: They often use recycled materials retrieved from their old products to re-design new products. Such companies often offer minimalist and durable product designs.

Some sustainable production and long-use/reuse business models not only help preserve the planet's biodiversity and reduce carbon emissions, they also benefit from reduced production costs through use of recycled products and have been able to turn sustainability into a strong profit driver. Such businesses can potentially charge higher prices for their high-quality products and attract and retain environmentally conscious, discerning customers who are willing to pay higher prices for durable and sustainable products.

Summary

Since the advent of modern capitalism, humanity has predominantly viewed nature as a mere resource or an extractive system meant to serve its needs, while externalising the costs to nature. Consequently, our ecological and climate systems are on the verge of a breakdown in the 21st century. With each passing day, there's a pressing need to foster greater harmony between humanity and nature, to preserve our ecological ecosystems.

This Earth Day, we try to re-imagine our relationship with nature – to move from exploitation to symbiosis. This calls for a shift from the linear economic model which is damaging biodiversity and natural habitats at an unprecedented scale, to a circular economic model.

The concept of 'circularity' signifies a regenerative symbiosis between humans and nature. It re-establishes the relationship humans have had with nature thus far - moving beyond extraction to foster a reciprocal co-evolution - and creates a new dynamic where human activities enhance and regenerate, rather than net exploit the biological ecosystems[3].

We see bottom-up investment opportunities in the **adopters** of circular economy in various sectors (the retail fashion industry for example); and in **enablers** – i.e., companies that deliver new and innovative solutions enabling others to be become circular; companies that supply alternative materials; waste disposal and the ones that supply recyclable alternative materials.

Through our **High Conviction Theme** titled *Biodiversity and Circular Economy*, we apply our investment lens to delve deeper into the opportunities that biodiversity loss prevention and the circular economic switch present to investors. Please reach out to your IC/RM to find out more about the investment opportunities under this High Conviction Investment Theme.

Sources:

1. OECD – Biodiversity: Finance and Economic Business Case for Action, 2019
2. McKinsey Global Institute, 2020
3. Dark Matter Labs, April 2024
4. World Economic Forum, Feb 2023

HSBC and Sustainability

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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 cancelled. 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. cotractual 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.

Contingent convertible securities (CoCos) or bail-in debentures are highly complex, high risk hybrid capital instruments with unusual loss-absorbency features written into their contractual terms. Investors should note that their capital is at risk and they may lose some or all of their capital.

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 nationalisation.

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 have a negative effect on the prices, mark-to-market valuations and your overall investment.

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.

Alternative Investments

Hedge Fund - Please note Hedge Funds often engage in leveraging and other speculative investment practices that may increase the risk of investment loss. They can also be highly illiquid, are not required to provide periodic pricing or valuation information to investors, and may involve complex tax structures and delays in distributing important information. Alternative investments are often not subject to the same regulatory requirements as, say, mutual funds, and often charge high fees that may potentially offset trading profits when they occur.

Private Equity - Please note Private Equity is generally illiquid, involving long term investments that do not display the liquid or transparency characteristics often found in other investments (e.g. Listed securities). It can take time for money to be invested (cash drag) and for investments to produce returns after initial losses.

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 nationalisation 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.

The leverage of a product can work against you and losses can exceed those of a direct investment. If the market value of a portfolio falls by a certain amount, this could result in a situation where the value of collateral no longer covers all outstanding loan amounts. This means that investors might have to respond promptly to margin calls. If a portfolio's return is lower than its financing cost then leverage would reduce a portfolio's overall performance and even generate a negative return.

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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In broad terms "ESG and sustainable investing" products include investment approaches or instruments which consider environmental, social, governance and/or other sustainability factors to varying degrees. Certain instruments we classify as ESG or sustainable investing products may be in the process of changing to deliver sustainability outcomes. There is no guarantee that ESG and Sustainable investing products will produce returns similar to those which don't have any ESG or sustainable characteristics. ESG and Sustainable investing products may diverge from traditional market benchmarks. In addition, there is no standard definition of, or measurement criteria for, ESG and Sustainable investing or the effect of ESG and Sustainable investing products. ESG and Sustainable investing and related measurement criteria are (a) highly subjective and (b) may vary significantly across and within sectors.

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