CHIEF INVESTMENT OFFICE

Impactonomics®

Sustainable Investing Under the New Administration

March 2021

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THE "S" IN ESG

We believe momentum in sustainable investing is likely to receive a boost from the Biden administration's pledge of social progress. Social factors—or the 'S' in environmental, social and governance (ESG)—will likely become imperative for corporations if they are to create long-term value for shareholders and stakeholders. Government and private sector alignment on how to shift to a stakeholder-first approach is critical, and the apparent coalescing would serve as a tailwind to sustainable investing and potential attendant inflows. With this in mind, we look at the macro and micro pushes toward social progress with key takeaways for investors.

THE MACRO CASE

A key question and starting point is to ask whether or not social issues like economic freedom, structural inequalities, a healthy workforce, and diversity of thought about gender, race, and immigration can drive positive macroeconomic outcomes. In our view, the answer is yes. And others concur: A growing body of academic literature is reinforcing the long-established view that key social factors underpin the key inputs to economic growth.

More to the point, economic output is a function of the labor force, utilizing existing capital or resources, and innovation. Social progress (or a lack thereof) plays a pivotal role in all of these areas. Labor force strength is anchored by a healthy, well-educated, racial and gender diverse workforce. Diversity of thought, an anchor of U.S. dynamism, helps drive team performance, research and development intensity and innovation. The social indicators that are useful in evaluating sovereign bond ESG risk from a macro lens include, among others, data related to innovation, health, and people (including income inequality, female labor force participation and education, for example).

Measuring and monitoring Social indicators has never been as important as today, and hence the proliferation of ESG data analytics over the past few years. To wit, in October 2019, the World Bank launched a sovereign-level ESG data portal in response to demand for data from investors looking to "manage and assess ESG risk" related to these factors. Meanwhile, the Social Progress Index (SPI), published by the Social Progress Imperative, provides data on "quality of life factors" in over 148 nations, including data on access to basic education, healthcare and internet access. The list goes on: There's the Global Innovation Index (GII), the World Economic Forum's "Innovation Ecosystem" benchmark, the Sustainability Accounting Standards Board, and various metrics and studies from numerous consultancies.

TWO OF THE FOUR CIO PILLARS OF SUSTAINABLE INVESTING

People

Commitment to engaged and healthy workers.

Prosperity

Contributions to equitable, innovative economic growth and sustainable communities.

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The key macro point is this: There's more to life than "gross domestic product (GDP)"—or traditional measures of output. The investment community—along with corporations, governments and households—is finally coming around to realize this fundamental fact. A nation's output, to be sure, matters. But what also matters is how this output is derived and how it is distributed—equitably or inequitably? Sustainably or unsustainably? For the sake of shareholders or stakeholders? The same questions pertain to corporations, since the earnings outlook for many firms rests on the shoulders of potential GDP output. Over the long run, you can't have one (earnings) without the other (output).

And broadening the lens, the total output of any nation is increasingly linked to female participation rates, family leave and child care initiatives, all non-traditional metrics of growth but growth metrics nonetheless. As Bill and Melinda Gates noted in their 2021 annual letter, "as governments rebuild their economies, it's time to start treating child care as essential infrastructure—just as worthy of funding as roads and fiber optic cables. In the long term, this will help create more productive and inclusive post-pandemic economies."

Hence, the Biden administration's laser focus on issues like child care, family leave and the "care economy", since the pandemic many women have been forced to exit the labor force, pulling down the U.S.'s female labor force participation rate from an average of 58.9% in 2019 down to 56.3% in April 2020, and rebounding only to 57% by January 2021.[1] Around the world, many women are leaving the labor force in droves as unpaid care work (unpaid household services) has surged during the pandemic. With more than three-quarters of that burden falling on women, the cost is enormous: Globally, according to the United Nations, a two-hour increase in women's unpaid care work is correlated with a 10-percentage-point decrease in women's labor force participation. Companies with the means to do so are prioritizing subsidized child care services, but this doesn't reach the majority of those hardest hit.

All of the above is another way of saying that investing increasingly pivots on the "S". We believe the potential for above-average returns lie with countries and companies that are actively working to improve access to quality healthcare and services, emphasizing greater diversity and inclusion, and that are abundantly aware of their social footprint in their communities. On a macro level, we believe the data is becoming clearer and more transparent.

The Micro Case: Private sector meets Public sector

Just as we need to leverage Social indicators to gauge macroeconomic activity, we also need to measure the success of execution at the company level. Companies that look to treat people as assets to invest in represent long-term investment opportunities—and 2020 highlighted how social aspects could materialize in financial performance.

One critical example of where this plays out is the health of a workforce (paid sick leave policies, etc.). How companies treat their workers and how that, in turn, benefits society matters—and investors are paying attention. JUST Capital observed significant alpha correlated to superior workforce treatment—the top quintile of companies with the highest workers' score has outperformed the Russell 1000 by 4.7% for a period of one trailing year; while the bottom quintile underperformed by 4.3% for a period of one trailing year.[2]

[1] U.S. Bureau of Labor Statistics, women 20 years and older, monthly data as of January 2021.

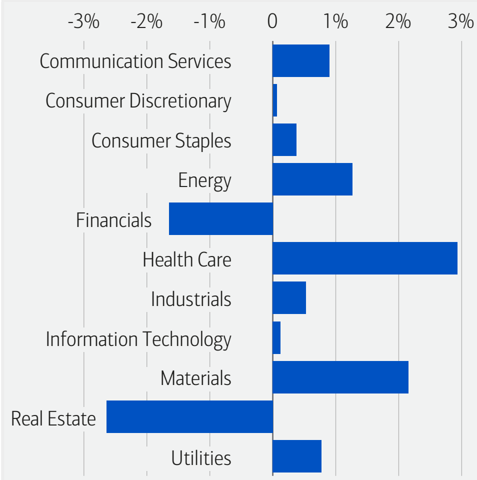
[2] Source: JUST Capital, as of August 31, 2020.

Performance during periods of exceptional market conditions should not be expected to be repeated in a normal market environment.

Performance results are extremely short term and do not provide an adequate basis for evaluating performance potential over varying market conditions or economic cycles. Investment results may have been different had another time period been chosen for this example.

CORONAVIRUS PLACES SOCIAL FACTORS IN THE SPOTLIGHT

Social factors have correlated with outperformers in nine of the 11 Global Industry Classification Standard (GICS) sectors in 2020, as the ESG spotlight has turned to how companies treat their employees, customers and suppliers. The strong relative performance of the healthcare sector dominates, aided by pharmaceutical names, which tend to have stronger social characteristics.



Source: MSCI All Country World Index. Reflects GICS sectors through the first six months of 2020. Federated Hermes, *ESG investing: How Covid-19 accelerated the social awakening*, June 30, 2020.

The pandemic has prompted companies and investors to put greater emphasis on how absenteeism, and poor access to paid leave and healthcare, may negatively affect the health and productivity of a workforce. A group of more than 300 investors representing over $9.5T in assets recently urged businesses to consider measures to help workers through initiatives like paid leave and avoiding layoffs.[3]

One global company recently announced that it will not do business with any firm or supplier that does not pay all of its employees a living wage, while other companies are offering many employees payment incentives to get the coronavirus vaccination. These plans hinge on the belief that a reliable and healthy workforce helps productivity and profits, and ultimately has the potential to decrease volatility.

At the federal level, President Biden's executive order on "Protecting Worker Health and Safety" directs federal regulators to issue stronger safety guidance and review enforcement policies for workplaces operating throughout the pandemic. Yet to be seen is how this will play out through workplace protections or the downstream effect for companies, but corporate commitments to expansion of health benefits and the urgent need for both health and safety practices are necessary to meet society's emerging expectations.

The pandemic has helped to demonstrate the urgency of transforming the workplace to be more diverse, equitable and inclusive, and those that lean away from workplace inclusion may be disadvantaging themselves for the future. Diverse teams have the potential to generate a competitive edge through increased consumer insight such as anticipating customer needs and consumption patterns, generating new products and services, and positioning for future growth and talent acquisition.[5]

The hallmark for a more inclusive capitalism is transparency, and when it comes to supply chains and product safety, it's no longer a choice. ESG disclosures increasingly tend to require companies to disclose their supply chain practices; these include environmental responsibility, human rights, labor practices, and ethics and corruption. The pandemic has helped to amplify the importance of resilient, sustainable and ethical supply chains, and companies that fail to provide adequate oversight and management could face regulatory scrutiny, not to mention economic losses and reputational risk. President Biden's "Made In America Executive Order"—designed to encourage government spending on "American goods made by American workers with American-made component parts"—may encourage onshoring portions of their supply chains, enhancing visibility, at a time when stakeholders continue to scrutinize them.

It's worth noting that the way a company manages ESG factors of a material nature is likely to have a greater influence over its performance than how it addresses non-material ones, and may be more important to investors.[6] Companies that embrace sustainable business practices on material issues had demonstrated the ability to increase revenue and decrease costs, including the cost of capital relative to peers.[6] As ESG analysis becomes entrenched in the investment world, this may affect both capital allocation decisions and financial performance.

As discussed, the pandemic has both intensified and highlighted a range of issues associated with Social factors affecting economic growth and corporate earnings. The pandemic has also brought forward public sector initiatives discussed that could ultimately affect growth and returns over the long run.

MSCI research indicates that "companies with above-average safety measures were less likely to suffer stock-specific share-price shocks than companies with poor safety standards."[4]

Source: MSCI: Deconstructing ESG Ratings Performance, June 15, 2020.

HIGHLIGHTING PRESIDENT BIDEN'S EXECUTIVE ORDERS RELATED TO SOCIAL FACTORS

- Multiple Executive Orders to ease immigration policies (1/20/2021)
- Promote racial equity (1/20/2021)
- Bars discrimination based on gender identity or sexual orientation (1/20/2021)
- Protecting Worker Health and Safety (1/21/2021)
- Ensuring the Future is Made in All of America by All of America's Workers (1/25/2021)
- Reverse ban on transgender Americans joining the military (1/25/2021)
- Executive order to end reliance on private prisons (1/26/2021)
- Executive order reaffirming commitment to tribal sovereignty (1/26/2021)

Sources: whitehouse.gov as of February 2021.

[3] See Domini.com "Investor Statement on Coronavirus Response.", April 23, 2020.

[4] Certain information contained herein (the "Information") has been provided by MSCI ESG Research LLC, a Registered Investment Adviser under the Investment Advisers Act of 1940, and may include data from its affiliates (including MSCI Inc. and its subsidiaries ("MSCI")), or third party suppliers (each an "Information Provider"), and may have been used to calculate scores, ratings or other indicators and it may not be reproduced or redisseminated in whole or in part without prior written permission.

[5] Source: McKinsey: *Diversity Wins: How Inclusion Matters*, May 19, 2020 / Hewlett, Marshall, Sherbin: *"How diversity can drive innovation."* Harvard Business Review, December 2013. Grant, Rock: *"Why diverse teams are smarter."* Harvard Business Review, November 4, 2016.

[6] Khan, Serafeim, Yoon: Harvard University: *Corporate Sustainability: First Evidence of Materiality,* February 1, 2017

The administration's agenda may rank well among ESG initiatives given their focus and prioritization of these policies, but, as discussed, equally as important is support from corporations and standard-setting institutions, which we expect to only gather more momentum in the future.

INVESTMENT IMPLICATIONS

In the end, ESG factors provide investors with an additional dimension to help identify market risks and potential opportunities, and we believe portfolio strategies in the coming years would allocate more capital to assets backed or underpinned by high-sustainability initiatives. Structural dynamics like rising political pressure and regulatory change are additional planks to sustainable investing and capital reallocation. Doing well and doing good have become strategic priorities of many firms and the asset managers that invest in them. Companies that are most transparent about their goals, and are better at execution, may reward investors. For example, full-year 2020 returns for the MSCI ESG Leaders Index gained 16%, while the MSCI All Country World Index (ACWI) returned 14.3%—performance that suggests an ESG leader aggregate is positioned defensively relative to its conventional peer.

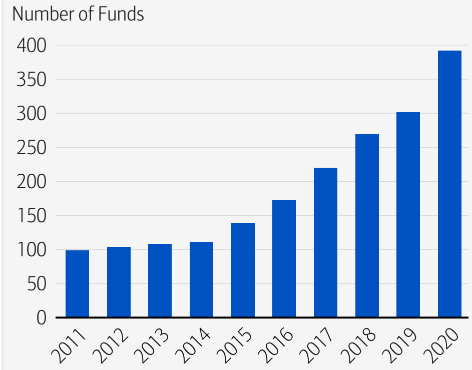
Investor demographics is also supportive of ESG flows, with Millennial and Gen Z investors more meaningfully aware and attuned to stakeholder capitalism versus shareholder. Per this generational cohort, a BlackRock survey[7] found that investors planned to almost double their sustainable assets under management in the next five years, from 18% today to an average of 35% by 2025. As a result of the accelerated adoption of ESG factors into the investment process seen in 2020 ($347 billion poured into ESG-focused investment funds),[8] we expect growing demand for sustainable solutions and strategies, which in our view, may offer a competitive risk-adjusted return profile within a traditional asset allocation framework.

With the help of governments, corporations and other groups, a combined $490 billion was raised last year selling green, social and sustainability bonds according to Bloomberg. April 2020 marked the first month social and sustainability bond issuance surpassed green bond issuance showing a shift in attention to the social bond market. Moody's expects sustainable-debt issuance to reach $650 billion this year—a more-than-30% increase from 2020. The U.S. market is easily dwarfed by the funds, flows and initiatives of the European market, reflective of the unrelenting regulatory and political forces in Europe. But we expect U.S. flows to gather momentum in the future.

In a post-coronavirus world, ESG considerations, with social issues chief among them, will likely remain a top priority for many companies and countries, with employee health (safety precautions, medical benefits, paid leave), along with diversity and inclusivity commitments commanding investor focus. The flows associated with capital oriented toward the United Nations Division for Sustainable Development Goals (SDG) should create challenges for lagging companies and countries, but possible opportunities for leaders.

We expect the societal trends and imperatives for corporations that have served as tailwinds last year to sustainable investments to further the momentum for quality ESG disclosure more broadly. Data challenges do persist—with analytics a key hurdle when considering broader implementation of sustainable investing. Help from the recent consolidation of ESG standards including financial accounting and sustainability disclosure is a strong signal of meaningful change in reporting.

A DECADE OF SUSTAINABLE FUNDS: A NEARLY FOURFOLD INCREASE



Source: Morningstar, Sustainable Funds U.S. Landscape Report. Data as of February 2021. Note: Includes funds that have been liquidated during this period.

[7] Source: BlackRock, Sustainability goes mainstream, September 2020.

[8] Bloomberg as of February 10, 2021.

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Social impact bonds are a relatively new and evolving investment opportunity which is highly speculative and involves a high degree of risk. An investor could lose all or a substantial amount of their investment.

The bottom line: Output and profits matter to investors. That's neither new nor about to change. What is new and changing is that other metrics have been gaining in importance in determining returns, flows, asset allocation decisions and the like. Now and in the future, many countries and companies may be increasingly judged on a series of ESG metrics. Reflecting this point, money flows into U.S. sustainable funds and accounts totaled $17 trillion at the beginning of 2020. That's a big number and big increase (+42%) from the beginning of 2018. However, the $17 trillion represents only a third of the $51.4 trillion in U.S. assets under management, which portends more upside in the future.[9] Globally, meanwhile, ESG assets under management are expected to have topped $35 trillion in 2020 and are expected to continue expanding in Europe, Japan and many emerging markets over the course of this decade.[10]

In terms of asset allocation, sustainable investing crosses various asset classes, with the build out of portfolios that integrate ESG metrics into core operations and activities. The goal is to help drive positive financial returns and positive effects for the environment and the community at large. The focus on ESG metrics is just one component of the overarching investment process of elevating and managing risk portfolios, and positioning investments for future potential above-average returns. But that said, this metric tends to become central to asset allocation and the construction of portfolios.

Sustainable investing has arrived and has ample room to grow at home and abroad.

Risk management and diversification processes seek to mitigate, but cannot eliminate risk, nor do they imply low risk.

Asset allocation and diversification do not ensure a profit or protect against loss in declining markets.

INVESTORS CAN PARTICIPATE IN REAL IMPACT IN MANY DIFFERENT AREAS WITHIN THE CIO SUSTAINABLE INVESTING FOUR PILLARS

People	Planet	Principles of Governance	Prosperity
Commitment to engaged and healthy workers	Commitment to climate and environmental sustainability	Commitment to ethics and societal benefit	Contributions to equitable, innovative economic growth and sustainable communities
			

[9] See "The 100 Most Sustainable Companies", *Barron's*, February 15, 2021.

[10] See "ESG Data: Mainstream Consumption, Bigger Spending," by Opimas, January 2019.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in dollars.

MSCI ESG Leaders Indexes are free float-adjusted market capitalization weighted indexes designed to represent the performance of companies that have high Environmental, Social and Governance (ESG) ratings relative to their sector peers, to ensure the inclusion of the best-in-class companies from an ESG perspective.

MSCI All Country World Index (ACWI) is a stock index designed to track broad global equity-market performance. Maintained by Morgan Stanley Capital International (MSCI), the index is comprised of the stocks of about 3,000 companies from 23 developed countries and 26 emerging markets.

Russell 1000 Index is a stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index.

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